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FINANCIAL REGULATION

HEARINGS

BEFORE THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

OF THE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JANUARY 21, 2009

WHERE WERE THE WATCHDOGS? THE FINANCIAL CRISIS AND THE BREAKDOWN OF FINANCIAL GOVERNANCE

MARCH 4, 2009

WHERE WERE THE WATCHDOGS? SYSTEMIC RISK AND THE BREAKDOWN OF FINANCIAL GOVERANCE

MAY 21, 2009

WHERE WERE THE WATCHDOGS? FINANCIAL REGULATORY LESSONS FROM ABROAD

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WHERE WERE THE WATCHDOGS? THE FINANCIAL CRISIS AND THE BREAKDOWN OF FINANCIAL GOVERNANCE

WEDNESDAY, JANUARY 21, 2009

U.S. SENATE,
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 2:07 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, Levin, Tester, Burris, and Collins.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. The hearing will come to order. Good afternoon and welcome. As our Nation begins work under our brand-new President to recover from the worst financial crisis since the Great Depression, we must ask how and why it happened. Is the existing U.S. financial regulatory system adequately equipped to protect consumers, investors, and our economy?

A new report[1] by the Government Accountability Office (GAO) that is the focus of today's hearing lays out a very persuasive case that the answer to that question is "no." Over time, as the financial services sector has grown, moved in new directions, or suffered from scandals or crises, Congress has usually responded in a piecemeal fashion, grafting new regulatory agencies on top of one another. As a result, responsibilities for overseeing the financial services industry are today shared by over 200 different regulatory agencies at the Federal and State level, not to mention numerous self-regulatory organizations, such as the stock exchanges.

GAO's report concludes that our current regulatory structure is outdated and unable to meet today's challenges and highlights several key changes in financial markets that have exposed significant gaps and limitations in our ability to protect the public interest. Some of GAO's observations are familiar to Members of this Committee. We have heard over the years about the careless lending practices that led to the current subprime mortgage crisis, the increasing number of overleveraged financial institutions that need to be bailed out by the government, the failures of credit-reporting agencies to provide credible ratings for increasingly complex financial products, and the inability of regulators to uncover or in some sense respond to the world's largest ever Ponzi scheme.

[1] The GAO Report referenced by Chairman Lieberman appears in the Appendix on page 366.

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It gives this Committee no satisfaction to note that some of these shortcomings were highlighted over 6 years ago in our investigation both by the full Committee and the Permanent Subcommittee on Investigations following the collapse of Enron. And there we noted the inadequacies of the credit-rating agencies and the failures of regulators to notice the red flags that warned of massive financial fraud. Rather than contributing to the stability of financial markets, our fractured regulatory system seems to encourage financial institutions to play regulators against one another. New and complex financial products have been created that bypass these antiquated regulatory regimes. In some derivatives markets, the regulation is absent altogether.

All in all, these problems surely contributed to the build-up of systemic risks and the eventual breakdown in credit and financial markets in the last year that has put millions of people out of work, destroyed so much of the savings and home values of the American people, and broken our economic confidence in the future.

We have called this hearing today to take a government-wide look at our existing structure of regulation of financial services. We have asked today's witnesses—Gene Dodaro, Acting Comptroller General of the United States, Professor Howell Jackson of the Harvard Law School, and Professor Steven Davidoff of the University of Connecticut School of Law—to tell us if the current regulatory system adequately protects consumers, preserves the integrity of our markets, and protects the safety and soundness of our financial institutions.

Given the scope of the crisis we face today on top of the crises that we have gone through over recent years, including—and I go back a little further here—the savings and loan scandals, the dotcom bubble, and the Enron accounting mess that I mentioned, we think that now is the time to think, not just about regulatory reform, but about regulatory reorganization. Personally, I have not concluded if the way to fix our current system is to establish a single overarching super-regulatory agency, like that which exists in other developed countries, if it would be wiser simply to improve the ability of the existing regulatory bodies, or if the answer is somewhere in between.

However, what I have concluded is that there are serious deficiencies in our current patchwork regulatory system, and before Congress can fix them wisely—and in a way that will not just respond to the last economic crisis or scandal but prevent the next one—I think we have to step back and carefully scrutinize how the pieces would best fit together. And that, I believe, is what our Committee is well suited to do.

President Obama has declared that reforming the current financial regulatory structure will be one of his top priorities in this first year of his presidency, and I think we all welcome that. Such legislation will come out of the Senate Banking Committee, although it does touch on agencies that are regulated by other committees, such as the Finance Committee, the Agriculture Committee, and the Commerce Committee. However, I believe that this Committee's unique authority concerning governmental organization and oversight, as well as the special investigative power of our Perma-

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nent Subcommittee on Investigations, requires us to get involved in this review and will enable us to help the Senate reach the right conclusions about how we restructure our system of financial governance to prevent future financial crises that can cause terrible economic pain.

You may ask, how are we going to do this if the bill is not coming out of our Committee? Well, we certainly can do this first with a series of hearings and investigations; then depending on the interest and will of Committee Members, to express our conclusions in a report, which we will forward to the Banking Committee; and perhaps, if we are so moved, to offer amendments on the floor later this year when the fiscal regulation reform proposal reaches the floor.

In any case, this is a matter of importance and urgency to our country, and I do believe that we have something to contribute to the Senate discussion and legislation.

Senator LEVIN. Senator Burris is here, and I would like to welcome him, since it is his first hearing.

Chairman LIEBERMAN. Senator Levin notes that Senator Burris is here. I have to get over a bad habit where I refer to him as "General Burris" because we were both Attorneys General, and we love that title. But, Senator Burris, I really welcome you. I know of your work, and although you came here, shall we say, in uncertain circumstances, I know you well enough to know that you are very well qualified to be an outstanding Member of the Senate and will contribute greatly to the work of this Committee. So I am delighted that you have chosen to be on the Committee, and we welcome you here today.

Senator BURRIS. Thank you, Mr. Chairman.

Chairman LIEBERMAN. A pleasure. Senator Collins.

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Thank you, Mr. Chairman. Let me also add my words of welcome to our newest Committee Member. I would also inform the Members of this Committee that we will be adding Members on the Republican side. I am very pleased that Senators McCain, Ensign, and Graham will be joining the Committee as well. So, once again, we will have a great complement of Members with which to do our work.

Chairman LIEBERMAN. And with that group, I might add, lively hearings and deliberations.

Senator COLLINS. This is true, Mr. Chairman.

Mr. Chairman, let me start by thanking you for holding this hearing today. I spent 5 years in State government overseeing financial regulation, so I have a great deal of interest in this area.

The spiraling financial crisis has harmed virtually every American family. December's job losses were the worst monthly decline since 1945 and drove the unemployment rate above 7 percent. Individual retirement accounts and college savings accounts, as well as university endowments and public and private pension funds, have suffered huge losses. Consumer credit and mortgage availability have become more restricted.

In the past year, more than one million homes have been foreclosed upon, and foreclosure proceedings are targeting two million

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more. Home prices are still falling, and at least 14 million households owe more on their mortgages than their homes are worth. The current crisis has its roots in the financial system, where a combination of low interest rates, reckless lending, complex new instruments, securitization of assets, poor disclosure and understanding of risks, excessive leverage, and inadequate regulation poisoned the normal flows of credit and commerce.

The financial system itself has not escaped this carnage. A year ago, American capital markets were dominated by five large investment firms: Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs. Now they have either failed, been sold to banks, or have converted to bank holding companies.

Tens of thousands of banking and investment jobs have disappeared. A year ago, we thought a "tarp" was for covering your roof after a hurricane. Now the Troubled Asset Relief Program (TARP), originally touted as a means for the Treasury Department to buy troubled assets from banks, has morphed into a mechanism for buying hundreds of billions of dollars in bank preferred stock and warrants in order to inject capital into those financial institutions. It is not sufficient for Congress to continue to infuse new money into the TARP, or simply to pass an economic stimulus package. We must also ask how to repair our system of financial regulation to minimize the risk that another crisis such as this might build up undetected and unchallenged.

As we consider the options for reform, the GAO's new report on financial regulation will be a valuable guidebook. It describes the structure of the current system, explains the system's inability to cope with shifting circumstances, and proposes criteria for judging reforms. GAO sums up our challenge: "As the Nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the Nation's needs in the 21st Century." That judgment confirms what this Committee has found in our hearings on commodity speculation and derivatives trading; that is, there are too many gaps between jurisdictions, too many financial entities and instruments that can create huge risks but are largely free from regulatory requirements, and too little attention paid to systemic risk.

We now understand that everyday activities by mortgage brokers, hedge funds, over-the-counter traders, investment banks, Freddie Mac and Fannie Mae, and others dealing in mortgage-backed securities, credit default swaps, and other instruments can create a crisis that affects virtually every home and business in America. Yet, of the dozen Federal agencies and hundreds of State agencies that are involved in financial regulation, it appears that not one is tasked with detecting and assessing systemic risks. We have seen the consequences of that flaw. The proliferation of unregulated and unreported credit default swaps created spider webs of commitments so that a few failures rippled into the destruction of major investment banks.

By accident or by design, there are many key players in the modern regulatory system who are unregulated or lightly regulated, including mortgage brokers, self-regulating exchanges and credit-rating agencies, hedge funds, and non-bank lenders. Without additional transparency into their operations, a new systemic risk

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monitor would find its mission difficult to achieve. These difficulties have become so obvious that it is now common to hear government and industry officials, as well as academic experts, calling for a new systemic risk agency or monitor and for a restructuring of regulatory agencies.

In November, I introduced a bill to correct two other glaring gaps in our regulatory system: The lack of explicit regulatory authority over investment bank holding companies, and the lack of transparency for credit default swaps. Regulatory reform is absolutely essential to restoring public confidence in our financial markets. I am convinced we could continue to invest billions of dollars in banks, but that if we do not put in place a new, strong regulatory system, the public's confidence, which is essential to the operation of our markets, will not be restored. America's consumers, workers, savers, and investors deserve the protection of a new regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk taking, and improves oversight, accountability, and transparency.

Mr. Chairman, I am going to ask unanimous consent that the remainder of my statement be introduced into the record since I realize we have only limited time this afternoon, and I could go on forever on what is one my favorite issues.[1] Thank you.

Chairman LIEBERMAN. Needless to say, I would be interested in having you go on forever, but without objection, we will enter the statement in the record.

Senator Levin is the Chairman of the Permanent Subcommittee on Investigations. He has some thoughts and plans with regard to the topic of our inquiry today, and therefore, I would like to call on him on this occasion as well for an opening statement.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Well, thank you, Mr. Chairman. Again, I would be happy to have this time deducted from my question period.

Chairman LIEBERMAN. Not at all.

Senator LEVIN. Mr. Chairman, I thank you and the Ranking Member for holding this hearing. History has proven time and again that markets are not self-policing. The Pecora hearings before a Senate committee in the 1930s pulled back the curtain on the abuses that gave rise to the Great Depression. Hearings since then have documented a litany of abuses by financial firms trying to take advantage of investors and markets for private gain.

In recent years, for example, Congressional hearings—including by the Permanent Subcommittee on Investigations (PSI), which I chair—showed how Enron cooked its books, deliberately distorted energy prices, and cheated on its taxes, becoming the seventh largest corporation in the country before its collapse. Our Subcommittee hearings also showed how leading U.S. financial institutions such as Citigroup, JPMorgan, and Merrill Lynch willingly participated in deceptive transactions to help Enron inflate its earnings. Some of our other hearings of PSI have disclosed that U.S. corporations engaged in misleading accounting, offshore tax

[1] The prepared statement of Senator Collins appears in the Appendix on page 346.

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abuses, excessive stock option payments, and other disturbing practices.

Our hearings in 2007 showed how a single hedge fund named Amaranth made massive commodity purchases on both regulated and unregulated energy markets to profit from distorted energy prices that they helped generate, causing U.S. consumers to pay more. Subcommittee hearings last year showed how Lehman Brothers, Morgan Stanley, and others helped offshore hedge funds dodge payment of U.S. taxes on U.S. stock dividends by facilitating complex swap agreements and stock loan transactions. Other congressional hearings have shown how Countrywide and others sold abusive mortgages, overcharged borrowers, and offloaded defective mortgage-based securities onto the market.

Part of the explanation for these recent abuses is a history of actions that have gradually weakened our financial regulatory system. Here is a chart, which I guess our audience can see, but we cannot, so I will quickly read what is on it.[1] The chart lists just a few of those actions over the last 10 years. Some of these actions are the following:

Back in October 1998, at the request of the Securities and Exchange Commission (SEC), the Treasury Department, and the Federal Reserve, Congress blocked funding for the Commodity Futures Trading Commission (CFTC) regulation of over-the-counter derivatives.

In 1999, the Gramm-Leach-Bliley Act repealed the Glass-Steagall Act of 1933, which separated banks, broker-dealers, and insurers.

In December 2000, the Commodity Futures Modernization Act prohibited swaps regulation, and opened the Enron loophole allowing unregulated energy markets for large traders.

In August 2003, the SEC delayed requiring auditors of private broker-dealers to register with Public Company Accounting Oversight Board rules.

In June 2004, the SEC weakened the net capital rule for securities firms.

In June 2006, the Court of Appeals invalidated the SEC regulation requiring hedge fund registration. We needed the SEC to come back to us and to ask for legislation. That did not happen.

In December 2007, the SEC allowed foreign companies trading on U.S. exchanges to use international financial reporting standards without a reconciliation to U.S. generally accepted accounting principles.

And these are just a few of the actions which have been taken.

It hasn't been all one way, although it has mostly been one way. After the Enron scandal, we were able to enact the Sarbanes-Oxley Act that strengthened oversight of the accounting profession, required stronger financial controls, and made a number of other improvements. Last year, we successfully closed the Enron loophole which barred government oversight of electronic energy markets for large traders. There is still more reform in that area needed. But, overall, stronger market regulation has been the exception, not the rule, and had to be won despite naysayers claiming that markets work best with minimal regulation. The current crisis

[1] The chart referenced by Senator Levin appears in the Appendix on page 356.

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shows that minimal regulation is a recipe for disaster, an overhaul of Wall Street regulation is long overdue, and Congress needs to act now to fix a broken system.

As Congress and the new Administration begin the work of financial restructuring and our Committee begins to examine these issues, I just want to briefly offer a few observations about needed financial reforms. The first is that Congress needs to put a cop on the beat in every financial market with authority to police every type of market participant and financial instrument to stop the abuses. We need to eliminate the statutory barriers, for example, that prohibit Federal regulation of credit default swaps, hedge funds, and derivative traders. We need to enact new limits on high-risk activities including preventing banks from running their own hedge funds and requiring the end of abusive offshore activities. Congress also needs to reduce the concentration of risk to the taxpayer by preventing any one bank from holding more than 10 percent of U.S. financial deposits, and to institute new protections to stop financial institutions from profiting from practices that abuse investors and consumers. I believe that we need to act on the substance of these abuses and to fill these gaps.

Finally, Mr. Chairman, let me just add one other thought. The Chairman and Ranking Member are undertaking a very important mission, which is to look at the structure of the regulations because that is within the jurisdiction of this Committee. And I do not want to, in any way, minimize the importance of that effort. But we also need to make sure that this effort puts additional pressure on the committees that have the substantive jurisdiction to take the steps necessary to close the gaps that have been created in this system, the regulatory gaps so big that some of the greediest members of our society have been able to very easily walk through the gaps, making billions of dollars for themselves.

And so, again, I want to commend you, Mr. Chairman. This is the more difficult part of the effort, the structuring part, and it is important to try to reach conclusions as to which agency is the proper agency to do the regulation. That is the who. But I believe the more urgent item, which I hope this effort will help support, is not so much the who, as important as that is; it is the whether—whether we are going to get a cop back on the beat. And this effort of our Chairman and our Ranking Member is, I know, aimed at supporting that goal because both of them have expressed and through their actions on this Committee have indicated the importance of the substantive reforms that need to be made to fill the gaps that have been created and the holes that have been gone through by too many greedy folks. And I want to commend you, Mr. Chairman, and our Ranking Member, Senator Collins, for your effort.

But, again, I just think we have to make sure that our effort in some way supports the critical substantive changes which both of you have spoken about, introduced legislation on, and fully support. I thank you.

Chairman LIEBERMAN. Thanks, Senator Levin. Your statement means a lot to me. I appreciate what you have said. That is exactly what we hope to do. Your support obviously will help us to do that. I think we can, through these hearings, both learn and educate

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others, and then reach conclusions which can help us to be advocates for the most effective regulation of the financial sectors of our economy that we are capable of doing.

I like what Senator Levin says, and if I may again go back to our earlier days as attorneys general, Senator Burris, there is a role within the chamber for advocacy among our colleagues for the most comprehensive and toughest regulation in this particular area because so much suffering has resulted from the lack of such.

Thanks, Senator Levin.

Let us go right to our witnesses now. First we are going to hear from Gene Dodaro, who, as I mentioned, is Acting Comptroller General. I will say for the record that Mr. Dodaro is accompanied by Richard Hillman, Managing Director of the Financial Markets and Community Investment Section of GAO; and Thomas McCool, Director of the Center for Economics, Applied Research, and Methods within GAO.

Thanks for being here. Thanks for an excellent foundational report, which we ask you to testify on now.

TESTIMONY OF EUGENE L. DODARO,[1] ACTING COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, ACCOMPANIED BY RICHARD J. HILLMAN, MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, AND THOMAS MCCOOL, DIRECTOR, CENTER FOR ECONOMICS, APPLIED RESEARCH AND METHODS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. DODARO. Thank you very much, Mr. Chairman. Good afternoon to you, Ranking Member Senator Collins, and other Members of the Committee. We are very pleased to be here today to assist your deliberations on the financial regulatory system.

As was mentioned, our report was intended to provide a foundation for how the system has evolved over the last 150 years, what changes have occurred in the markets that have challenged that regulatory system and caused some of the fissures that we have seen, and to put forth a framework for helping the Congress craft and evaluate proposals in order to modernize the system. Our basic conclusion is the system is outdated, it is fragmented, and it is ill suited to meet the 21st Century challenges.

Now, there are many reasons why we come to that conclusion in the report, but I will highlight three main points right now.

First is that regulators have struggled and often failed to address the systemic risk of large financial conglomerates or to adequately ensure that those entities manage their own risks. Now, over the last two decades, financial conglomerates have developed through mergers and acquisitions, and they have developed and gotten into banking, securities, insurance, and a wide variety of services. And while this has occurred, basically our financial regulatory structure has remained relatively the same, set up on a functional basis. This has caused tremendous coordination problems, which are documented in some of our reports, and raises questions about the au-

[1] The prepared statement of Mr. Dodaro appears in the Appendix on page 105.

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thorities and the tools available to regulators in order to address these concerns.

A vivid example is the difficulty and the ultimate failure of the SEC's consolidated supervision program, which failed to address the holding company risk of many of the investment banks over this period of time. Our reports have also documented some of the challenges that the Office of Thrift Supervision had in managing such—or regulating holding companies activities of the type that AIG had conducted.

The second major trend is the fact that the financial regulators have had to deal with now some of the problems that have been created by entities that have been less regulated. These include the non-bank mortgage lenders, the hedge funds, and the credit-rating agencies.

For example, just to give you some significance of the size of this, in 2006, for the mortgage origination loans for subprime and non-prime entities, of those 25 institutions that made those loans, which made up about 90 percent of all loans—it is about $543 billion in loans. Of the 25 entities, only four were not non-bank lenders. So you had a lot of activity going on that was growing over this period of time that was not subject to the same type of regulation that commercial banks were experiencing during this period of time.

The third trend was the emergence of a wide variety of complex financial products, as has been referenced here in the opening statements: Collateralized debt obligations, credit default swaps, over-the-counter derivatives, and mortgage products that were innovative and did not have the type of disclosures that were needed. All this confused investors and others and complicated attempts to have a complete picture of this.

The other conclusion that we come to is there is no one central entity that is basically charged with looking at risk across the system, and this is a major deficiency in the current structure that needs attention.

Our view is that reform is urgently needed, and unless it is approached and dealt with soon, the vulnerabilities that we have all talked about this morning are going to continue to remain in the system. And that just can't be as we go forward as a country and try to stabilize the system and move forward in economic development.

Our framework is intended, though, to say a couple things. One, the reform needs to be approached in a comprehensive manner so that we do not react as a country, again, in a fragmented approach. And our nine characteristics that we set out are intended to help in that regard to make sure that all critical elements are addressed.

Those nine characteristics deal with a couple of very important topics. I will just highlight a few quickly.

First, we believe there need to be a clear articulation of the goals of the regulatory system set in statute. That would provide consistency over time and also enable Congress to hold the regulators accountable for achieving those results.

It has to be appropriately comprehensive, another characteristic. We need to close the gaps with some of the large entities that are

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posing risk and many of the products. We have to move to both cover the entities as well as the complexity of these financial products.

It has to be systemwide. Somebody needs to be in charge of monitoring the system and focusing on the development of risk going forward. We all know where the risks are now, but they are likely to change over a period of time. So we need to close the gaps and put a process in place to monitor this on an ongoing basis.

It needs to be flexible and adaptable. We need innovation to allow for capital formation, but somebody has to make determinations on what the level of risk is that is acceptable with those innovations and make some early decisions and not wait until the consequences have become so dire over time.

We need to have an efficient system. There is a lot of overlap right now. The overlap can be dealt with as part of the reform.

There need to be strong consumer protections. It is clear from our work and the work of others, as referenced in Senator Levin's comments and the opening statements both by the Chairman and Ranking Member, disclosures have not been adequate.

There also needs to be greater attention to financial literacy efforts. We have looked at the entity that has been put in place in the Federal Government to provide that, but it has not been resourced properly, and not enough attention has been given to that particular area.

We have to make sure that the regulators are independent, resourced properly to preserve that independence, and given the necessary authority to move forward.

And, finally, we need to protect the taxpayers. Any risks that occur in the future should be borne by the entities being regulated and not by the taxpayer. That needs to be our goal, and we need to minimize taxpayer exposure so we do not go through again what we are currently going through across the country.

This is a very important initiative. GAO is pleased to assist this Committee and stands ready to help this Committee and the Congress deal with these very important issues and decisions going forward. And my colleagues and I would be happy to answer any of your questions at the appropriate time this afternoon.

So thank you very much.

Chairman LIEBERMAN. Thanks very much, Mr. Dodaro. That is a very good beginning for us.

We are grateful that Professor Howell Jackson from Harvard is here, and we are also grateful that President Obama and the new Administration are not taking everybody from the Harvard Law School faculty. [Laughter.]

In fact, if I am correct, the President's nomination of Dean Elena Kagan to be Solicitor General has moved you now to be the Acting Dean of the Law School. Is that right?

Mr. JACKSON. That is true.

Chairman LIEBERMAN. If so, I congratulate you and wish you well. Thanks for your testimony. We will hear it now.

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TESTIMONY OF HOWELL E. JACKSON,[1] JAMES S. REID JR. PROFESSOR OF LAW, HARVARD LAW SCHOOL

Mr. JACKSON. Thank you very much. It is a pleasure to be here, Senator Lieberman and Senator Collins. I am delighted to have a chance to participate in this hearing and begin the process, I hope, of genuine and serious regulatory reform in this country, which is long overdue.

Let me begin by just commending Government Accountability Office for its fine report. I think it does an excellent job both pulling together its prior work on the subject and also laying out the major weaknesses in our regulatory structure. And I agree with almost everything that is in the report. The regulatory gaps that exist have created serious problems for our economy. There is a serious mismatch between our regulatory structure and the 21st Century financial services industry, particularly to the extent that financial conglomerates dominate and are able to play off different regulatory agencies against each other and find this unregulated space to expand products.

I think that one of the things the report highlights in passing that is important to recognize is the world has really moved ahead of us in the area of regulatory reform. If you go around the major countries and look at the legislation that they have been adopting over the past 5 to 10 years, it has all been a movement towards consolidated supervision that puts us at a serious disadvantage.

We have the anomalous situation in this country of having the world's most expensive regulatory structure in both absolute terms and relative terms, but one that has failed to provide us the kind of protections that we need. So this Committee's agenda is very much in need of setting an agenda for the whole Congress.

What I thought I would do is comment upon five areas in which I thought it would be useful to discuss some of the ramifications of the GAO study in areas where I think the weaknesses are particularly important for this Committee to note.

The first has been touched upon, and I just want to talk about it a little bit more, which is the absence of a market stability regulator, something that Senator Collins mentioned, and it is certainly the case that this is a problem.

The Federal Reserve Board was set up to be our market stability regulator in a time when systemic risks were thought to lie solely with depository institutions, with banks, and having a lender of last resort function, oversight of bank holding companies, and member banks was thought to be an act of protection, and I think in the middle of the 20th Century that was the case. Since the middle of the 20th Century, the role of depository institutions has declined. Other sectors, most notably capital market sectors, have expanded dramatically. And it is not surprising today that when we look to see where the system risks came from, they came from other sectors of the economy. They came from the investment banking sector; they came from the over-the-counter (OTC) derivatives area; they came from innovations in mortgage lending—all things that were not contemplated in the past. And so we need to have a regulator of market stability that can see all potential sources of

[1] The prepared statement of Mr. Jackson appears in the Appendix on page 133.

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regulatory risk, including insurance companies and other areas of the economy.

I think that it is appropriate to think of the Federal Reserve Board as the candidate for having that expanded power, and I know today is not the day to talk about the exact structure of regulatory reform. But I would just point out five areas of weakness with the current oversight of market stability. One is the cramped jurisdiction that the Federal Reserve Board has, now limited to a certain number of areas, not including insurance companies, not including many other areas of importance systemic risk.

Another problem is the manner in which the lender of last resort powers are structured. It has been remarked by many people that the Federal Reserve Board had to operate at the boundaries of its powers. Now, I think it acted legally, but it was constrained in how it provided liquidity in the past 6 months. I think that is something that needs to be clarified in regulatory reform.

I think, as was just alluded to by Mr. Dodaro, the mechanisms for ensuring that the costs of systemic risk are borne by the sectors of the industry that generate those problems is an important weakness of our current structure. The systemic intervention powers of the Federal Deposit Insurance Corporation (FDIC) are charged back to the banking sector if they are used. The TARP has an aspirational provision for recouping some funds, but we need to have a comprehensive approach to recouping funds to make sure that the incentives are right in the financial services industry, that they will bear the cost of systemic risk when they arise.

I think it is also important to recognize that the Federal Reserve Board needs to expand its expertise to go beyond the traditional areas of jurisdiction. The crisis with AIG and the investment banks show that it needs to have broader expertise and greater personnel skills in many areas that are not traditionally supervised. Whether you want the Federal Reserve to be a comprehensive supervisor I think is a difficult question of regulatory design, but I think if it is going to be the market stability regulator, it has got to expand its knowledge in certain areas.

There may well be things that the Federal Reserve currently does that it does not need to do in the future that should be reassigned to other places. But if we are going to have an effective market stability regulator, we need to think more broadly about the powers of the Federal Reserve.

Finally, it is important to recognize that many of the solutions to systemic risk and market stability need to be done on the front end. The regulation of clearing and settlement systems, limitations on investments, problems generated by the number of investments in Fannie Mae and Freddie Mac securities—these are all ordinary supervisory issues, and we need to have a mechanism where the market stability regulator can speak to the front-line regulators and, in my view, have a veto or an override if it thinks those other regulators are not addressing market stability issues. It is a weakness in the structure that the Federal Reserve comes in after the fact, not in front, and it is inevitably more costly to correct things after the fact, and that is a weakness.

Let me go on to just mention a couple of other areas of weakness that I think it is worthwhile for this Committee to focus on, and

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the second one that I want to mention is actually Congress' role in the current difficulties, or at least the statutory structure that Congress has helped create.

We have a regulatory system that has lots of legalistic divisions in regulatory authority, where the boundaries are written in very cramped ways, every regulator has its jurisdiction, and each regulator is jealously guarding its jurisdiction against other regulators. That leads to a situation where the industry can play regulators off against each other and exploit regulatory loopholes, and the regulators are inherently at a disadvantage.

One of the items on Senator Levin's list was the failure of the SEC to oversee hedge funds. That was a decision by the Court of Appeals of the District of Columbia based on an interpretation of statute. Now, I don't agree with the interpretation of the court in that case, but it was a problem for the SEC that it had no jurisdictional authority.

One of the things that we need to do in regulatory reform is to create broad jurisdictional mandates so that the regulators have the power to go into areas and do what needs to be done rather than having cramped constraints.

The division of regulatory authority is also totally clear in the problems of the mortgage banking industry. If you look at the regulatory structure that we have created in this country, the Department of Housing and Urban Development (HUD) had a piece of consumer protection for mortgage loans. The Federal Reserve Board was responsible for subprime loans. There were at least five Federal agencies in charge of depository institutions that were making the loans. The SEC was responsible for the securitization process in the credit-rating agencies. State regulators had some powers over mortgage brokerage transactions. And actually just this last summer, we created a new licensing process for mortgage brokers.

It is no surprise that in a regulatory structure that is so fragmented no one saw the homeownership problem arising, and that there is no single agency to point to for responsibility after the fact.

Another area that has been alluded to already this afternoon but I would like to mention is the problem of regulatory expertise and competence. This is, I think, most apparent if one looks around the world and sees what happens when other regulatory agencies are consolidated together. And one of the things that happen is the quality of personnel that is willing to work in the regulatory agencies goes up. Professionally, it is a broader mandate. There are more professional experiences. There are fewer positions that are taken by political appointees. It is a more attractive career position that attracts higher-quality personnel when we have a broader mandate.

I think it is also the case to recognize that when you have a narrow regulatory function, it is hard to have expertise in every area. So the failure of Bear Stearns actually is a pretty good example of this because when the investment bank was getting into trouble, the SEC had to look to the Federal Reserve Bank of New York to get the personnel it needed to understand the problems. The Federal Reserve Board has a large number of economists that study banking issues in great detail, but the SEC has never had that

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kind of expertise, and it has lacked the bench strength to address many of the problems before it.

So we have a mismatch of personnel. We have an inability to move personnel from one sector to the other, which seriously constrains us in terms of risk and is a weakness of our system.

Another weakness of the fragmented system is the vulnerability of specialized regulatory agencies to the problem of regulatory capture. If you are an agency and you just regulate one sector of the financial services industry or one subsector, you are much more likely to identify with the success of your constituent institutions. So I would say the Comptroller of the Currency and the Office of Thrift Supervision, in order to make the national charters more attractive, cavalierly preempted State law of consumer protection, to the great detriment of the consumers of the regulated banks, and also making the task of State regulators much more complicated as Federal entities were coming in with preemption and State entities were being subject to full regulatory structure.

I think there are many reasons one can explain that, but part of the reason was the agencies much too much identified with their constituents rather than thinking about what was in the best interest of the economy and the general public.

I think in the area of consumer protection, this has already been touched upon, but to the extent this Committee is looking at shortcomings of consumer protection, I think the fragmented regulatory structure is also a source of concern here. There are lots of functionally similar products that are regulated in different ways because different regulatory agencies have expertise over them. If you are a clever attorney, you can make an insurance product look like a securities product or a banking product look like an insurance product or an insurance product look like a securities product and get a different regulatory structure. And there are many examples of repositioning to take advantage of marginal differences in regulation. That confuses the consumer, and it creates inconsistent protections across the financial services industry.

In the area of financial education, which I think is tremendously important, in the end we depend on consumers to understand the products, and we need to have those consumers be educated. There is ample academic evidence that shows that less educated consumers make poor choices, take worse mortgages, have worse credit card terms. So financial literacy is a major goal, but it cannot be done on a piecemeal basis. We cannot have 200 different agencies engaging in financial education. It needs to be a centralized function. It needs to be a function that attacks the problem of financial literacy in a comprehensive way. It needs to interact with the educational system. That needs to be centralized, and fragmented financial education really is no financial education.

The final point of weakness that I want to mention is also covered in the GAO report, but it is just worth noting. We live in an increasingly globalized financial market, and a major task of financial regulators is to interact globally, to work with regulators overseas. And there are a variety of reasons for this. Among other things, we need to make sure that transactions are not just escaping overseas and obtaining lower regulation in other jurisdictions, but there is cooperation that needs to be done in terms of enforce-

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ment actions, memoranda of understanding, and working out consistent regulatory systems.

Our fragmented regulatory system is poorly suited for this task, having multiple entities going overseas to interact with unified regulators in other countries. When you are overseas, it is a common complaint about the United States that you cannot talk to one person, you have to talk to a dozen people. There are monthly visits by different regulators from the United States to London, to Tokyo, to Hong Kong, and it is an ineffective and inappropriate system.

In many areas, such as in the banking area, we have multiple regulators representing the United States on the same issues. That complicates negotiations, makes it more difficult to work with our allies, and is a serious impediment to effective regulation. So I think the interactions on the international side are a separate area of concern that one should look for.

I should say in this area, since it is in the Committee's mandate, there is a lot of expertise internationally on how to do regulatory reform. Many other jurisdictions have gone through the process, and I think particularly the British model is one to look at for some very interesting examples of structuring the reform, which very much needs to be done.

Let me just close by saying the current financial situation is a challenge on multiple levels for this country, and for the most part our task is regaining our economic strength and trying to restore lost value to the people of this country. The one silver lining to the current crisis is it gives us an opportunity to reform our regulatory structure. That is something that has long been overdue. It has been a difficult political task to take on. But we finally have the opportunity to address a problem of a major sort for the United States, and I hope this Committee will take leadership in addressing that concern. Thank you very much.

Chairman LIEBERMAN. Very well said. Thank you.

Professor Steven Davidoff is on the faculty of the University of Connecticut School of Law. I think I overheard you say you had been at Michigan before.

Mr. DAVIDOFF. Wayne State University Law School.

Chairman LIEBERMAN. Wayne State, so you claim you do not have any connection with the State of Maine?

Mr. DAVIDOFF. No. But I have been there many times, and it is a lovely place. [Laughter.]

Senator LEVIN. And you apparently still have a place in Ann Arbor?

Mr. DAVIDOFF. Sadly, I have a house in Ann Arbor that I am unable to sell. [Laughter.]

Chairman LIEBERMAN. Senator Levin raised this subject.

Mr. DAVIDOFF. It is not Senator Levin's fault.

Senator LEVIN. I did not know that part or else I would not have gotten into it. But Wayne State University Law School, if I could say, Mr. Chairman, is the law school where my wife graduated. She is a lawyer.

Chairman LIEBERMAN. Well, that speaks for the quality of the law school.

Mr. DAVIDOFF. It is the true public law school of Michigan.

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Chairman LIEBERMAN. Senator Levin is known for his constituent service, and I am sure he will do anything he can to help you sell your house in Ann Arbor. [Laughter.]

Mr. DAVIDOFF. I like my house. Ann Arbor is a lovely place.

Chairman LIEBERMAN. With all of that, Mr. Davidoff, I am proud that our staff search for experts in this happily led us to somebody who is now at the University of Connecticut Law School. Please proceed.

TESTIMONY OF STEVEN M. DAVIDOFF,[1] PROFESSOR OF LAW, UNIVERSITY OF CONNECTICUT SCHOOL OF LAW

Mr. DAVIDOFF. Thank you. Chairman Lieberman, Ranking Minority Member Collins, and other Members of this Senate Committee, I want to start by thanking you for providing me an opportunity to testify today.

I would like to start by agreeing with the uniform sentiment expressed today that today's financial regulatory architecture is fractured, archaic, and ill suited to today's modern financial world.

What I would like to do in my testimony is fill out the excellent GAO report by providing a short narrative of the deficits of the past few years, which aptly illustrates the failures of the regulatory system and its current fractured nature. I want to start with the root causes of the financial crisis.

The causes of the current financial crisis are still the subject of much study and debate, and will remain so long after Congress acts on any financial reform. Nonetheless, at this point, 18 months into the crisis, we have a rough sketch. In summary, historically low interest rates led to excessive borrowing by both individuals and financial institutions. The consequence was the rapid rise of housing prices. These prices were increased by demand from so-called subprime borrowers.

During the period from 2000 through 2006, the amount of outstanding subprime mortgage debt grew an astounding 801 percent to $732 trillion. These loans were often issued and underwritten under the assumption that "housing prices do not fall." The assumption proved all too incorrect. And it is now all too clear that in many instances borrowers were placed into loans that they cannot now afford.

Theoretically, bankers should have been more concerned with whether their loans would be repaid. However, the traditional "It's a Wonderful Life" banking model where lenders and borrowers passed each other on the street and lenders personally assessed the creditworthiness of their clients has long past. Mortgages are now securitized into asset-backed facilities called collateralized debt obligations (CDOs), and sold into the market. Lenders now serve as intermediaries in this "originate to distribute" model and are more concerned with the ability to sell these loans rather than whether they are repaid. Many of these lenders, particularly for subprime mortgages, were non-bank lenders subject to differing oversight and regulation than their bank counterparts.

It is now clear that this new securitization process allowed for lax lending standards. In 2005, the SEC contributed to this by lib-

[1] The prepared statement of Mr. Davidoff appears in the Appendix on page 143.

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eralizing the registration process for these securities. At that time, the SEC discarded the obligation of underwriters of CDOs to perform due diligence on these CDOs to confirm adequate loan documentation. In essence, for those CDOs that were registered, the SEC relied upon private underwriters to uphold standards. Here, the underwriters also procured a private ratings agency to rate the CDO's tranches. Notably, though, the SEC, due to regulatory restrictions, was only responsible for regulating affirmative disclosure in the securitization process when the underwriter chose to register the securities. In no instances, as Professor Jackson highlighted, was the SEC responsible for the mortgage origination process or disclosure. In fact, financial disclosure, again as Professor Jackson highlighted, is subject to multiple regulatory agencies, none of which have the primary goal of consumer financial disclosure.

In addition, under the Credit Rating Agency Reform Act, the SEC was affirmatively denied the ability to regulate the procedures and methodologies by which any rating agency determines credit ratings. In hindsight, the SEC and other financial regulatory agencies lacked complete oversight over the mortgage securitization market, and it was a market that was, at best, subject to overlapping and conflicting regulation. This allowed market failure as lenders, rating agencies, and borrowers all contributed to lax borrowing standards and the taking of excess risk, the consequences of which we are now dealing with now.

During the period from August 2007 through March 2008, banks rushed to recapitalize their balance sheets from private investors. Nonetheless, the week of March 11, 2008, Bear Stearns collapsed. In hindsight, the largely unregulated investment banking model was overly susceptible to shock. Unlike bank holding companies, investment banks historically had a leverage model ranging from 20:1 to 30:1 and relied on short-term, highly movable deposits for liquidity. These deposits came from hedge funds, for the most part—sophisticated financial institutions that could quickly move their assets in the case of a crisis, and this is what they did, leading Bear Stearns to lose liquidity and into a forced sale.

The fall of Lehman Brothers was due to similar factors. At the time, there was a significant outcry that the failing of Lehman and perhaps Bear Stearns was due to shorting of their stock in the market and the crisis in confidence it created. In some cases, it has led to cries for regulation of the credit default market and a prohibition on shorting. Credit default swaps (CDSs), notably, were deliberately legislated to be left unregulated by Congress in the inaptly named Commodity Futures Modernization Act. The veracity of these claims about shorting and CDSs is unknown at this point. But, in fact, due to the lack of information about trading in the CDS market, I doubt anyone will ever be able to definitively conclude one way or the other on this point.

The full role of derivatives generally in the financial crisis still appears uncertain. Certainly in some circumstances, derivatives increased risk, heightening the impact of the rapid decline of the CDO market. More certainly, AIG was brought down because of underwriting of credit default swaps out of a London-based subsidiary. AIG was able to leverage a regulatory gap. It was regu-

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lated by the Office of Thrift Supervision as a savings and loan holding company because of AIG's control of a thrift, but AIG was not subject under this regulation to the same scrutiny or heightened requirement it otherwise would have been subject to had it been a bank holding company.

Furthermore, the Inspector General of the SEC issued on September 25, 2008, a report on the SEC's now defunct voluntary regulation program of the five investment banks, the voluntary Consolidated Supervised Entity (CSE) program. The program was doomed to fail and understaffed from the start. Three SEC employees were assigned to monitor each bank with tens of thousands of employees. The SEC never conducted appropriate, in-depth inspections as to risk measurement, capital liquidity sources, and other disclosure for these investment banks.

This was true even after Bear Stearns fell. The investment banks were able to leverage a regulatory gap to avoid in-depth scrutiny of their leveraging and risk processes and be regulated to the same level as bank holding companies are.

I want to spend the next few minutes just talking about the government response to the financial crisis and, again, how it illustrates the fractured nature of today's regulation and regulators.

Initially deprived of statutory ability to fully address the crisis, the government would engage in what Professor David Zaring and I call "regulation by deal" in order to attempt to salvage the financial system. In a series of transactions, the government nationalized Fannie Mae and Freddie Mac, bailed out AIG, and arranged for the sale of Wachovia and the banking deposits of Washington Mutual. Then with the passage of the Emergency Economic Stabilization Act and the adoption of the TARP program, the Treasury Department agreed to invest—or force financial institutions to invest, depending upon who you speak to—$125 billion in the country's nine largest financial institutions.

Since that time the government has been administering the TARP; along the way the bailout of AIG has been reworked, Citi and Bank of America have received a second set of TARP funds—$90 billion in total—and General Motors (GM) and Chrysler have also received TARP funds under the automotive component of TARP. Meanwhile, just today Treasury Secretary nominee, Timothy Geithner, part of the prior team, announced his desire to rework the entire program.

Each of these deals has been on different terms and structured seemingly on an ad hoc basis, without any organization or systematic approach. From news reports in the *Wall Street Journal* and other sources, it appears that the coordination of the FDIC, Treasury, and Federal Reserve on these individual bailouts was sometimes strained by disagreement over each of their regulators' role and statutory capacity. This may have contributed to the ad hoc nature of the government's response. The statutory limitations on these agencies, as Professor Jackson alluded to, and the lack of an in-place lender of last resort also affected the regulators' ability to fully respond to the financial crisis.

I note that the perceived cure to a panic and general credit freeze is to restore confidence in the markets. This has at times been

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sorely lacking among the populace due to the regulators' perceived ad hoc response to the financial crisis.

In conclusion, this brings us to today. I do not have time in my testimony to recommend solutions, but Congress will clearly hear many, and I offer some in my written testimony. Here I want to conclude by answering the question posed by this hearing: Where were the watchdogs?

Well, in part, as you can see from my sad narrative, the regulators were hobbled by their deregulatory bent and limited, fractured, and overlapping jurisdiction which left wide parts of the financial system without oversight or regulation. Thank you.

Chairman LIEBERMAN. Thanks, Professor Davidoff. That was an excellent narrative, really an excellent summary of how we got to where we are. I must say that insofar as I expressed in my opening statement our intention and hope that in these hearings we would learn, so we could help to educate, and then advocate effectively, I think all three of you have been excellent educators of the Committee, and I thank you for it.

We will have 7-minute rounds of questions. I will begin now.

A clear conclusion that you all share—and it begins with the excellent GAO report—is that the current system for regulating financial institutions in our country is fractured, out of date, and just not able to deal with today's complicated and immense global financial networks that do business here in the United States.

I was thinking as you were testifying that we have all become over the last year or so familiar with a term that I had not heard before, which is that an entity can be "too big to fail." Right? And so we end up spending or extending billions of dollars either of direct aid or credit.

From what you are saying, it sounds like it may not be that these entities are too big to regulate, but they are certainly too big and complicated for our current regulatory system to oversee in the public interest. And that is a big part of the problem.

I take it, just to start with the baseline question, that it is reasonable to conclude, both from the report and the testimony, that none of you thinks that simply fixing some of the specific authorities of existing regulatory agencies is enough to prevent the next regulatory crisis without a larger, comprehensive reform. Mr. Dodaro.

Mr. DODARO. Certainly there are some parts of the current regulatory structure that you may want to look at.

Chairman LIEBERMAN. Right. Sure.

Mr. DODARO. But we do not think that you can adequately address this problem in a comprehensive manner without making broader changes.

Now, on the point that you mentioned about some of the sizes of the entities and them being too big to fail, questions have to be asked about the extent of whether or not they are too big to manage effectively.

Chairman LIEBERMAN. Right.

Mr. DODARO. One of the really important themes, I believe, that runs through a lot of this issue is the whole question of risk management approaches and models, risk management at the individual institution level, at the industry level, at our national U.S.

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level, and at a global level. And I think that issue really needs a lot of attention from a regulatory standpoint, but also a corporate governance standpoint.

Chairman LIEBERMAN. I was wondering whether you were suggesting that there ought to be some governmental regulatory mechanism that may say to a financial entity this next acquisition you have in mind or the next product line you are putting out is too much. In some sense, it sounds like a classic antitrust function. It is a little bit different, of course. But what would you say to that?

Mr. DODARO. Well, I would say you need some checks and balances in the system. Ultimately, the company's management and the board of directors are responsible, but there has to be a threshold of risk as to whether or not the regulators are adequately achieving the goals that would be set up with the new system and protecting investors and taxpayers, in particular.

So this whole question of how to achieve the proper balance between regulating and allowing innovation, I think, is really going to be the tough underlying issue that really needs to be addressed, because there is a tendency to overregulate and have things roll back over time. Neither one of those is really the optimum solution. So, our characteristics are intended to try to get to see what can happen with that balance.

We also point out that there needs to be an adequate transition period in terms of whatever change, but also, Mr. Chairman, I would say the really other important part of this is diligent oversight on a continual basis by the Congress. The likelihood that this is going to be solved with one big stroke is really——

Chairman LIEBERMAN. One big move, understood. That is always a danger here. We legislate, we reform, and then we walk away.

Mr. DODARO. Because things change, markets are going to be fluid, and there needs to be some built-in oversight on a regular basis.

Chairman LIEBERMAN. Professor Jackson, you made some interesting statements about the possibilities of expanding the authorities and powers and jurisdiction of the Federal Reserve Board. Given your druthers, would that be at the heart of your comprehensive reform? And if so, would you blend or have the Federal Reserve absorb some of the existing Federal financial regulatory agencies?

Mr. JACKSON. Senator, that is a good question, and certainly one model that one could think about is to say the Federal Reserve is at the heart of the system with the best expertise, and we will fold everything in or a lot of things in to make a super agency.

That is not personally what I would favor. I think that the amount of centralization of authority is antithetical to a lot of American traditions. And, more importantly, I think what you want is a focused regulator with specific tasks.

So I would prefer a model of the Federal Reserve Board having broader powers for market stability issues to sort of have a roving mandate throughout the system, but another counterweight Federal agency with consolidated supervision that would be responsible for the front-line authority.

Chairman LIEBERMAN. So create a new agency that would take in some of the existing agencies.

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Mr. JACKSON. Yes, consolidated in the new agency. It would have front-line supervision, and all the consumer protections in day-to-day activities and have the Federal Reserve Board as an expanded oversight entity that does the market stability functions and with the lender of last resort capacity to come in should the need arise.

Chairman LIEBERMAN. Interesting.

Mr. JACKSON. It is a little bit like the British model, except I would envision a more robust role for the Federal Reserve than the Bank of England has.

Chairman LIEBERMAN. Got it. Professor Davidoff, I have about a minute left in my time. Why don't you get into this discussion. What would be your druthers if you were redesigning the system?

Mr. DAVIDOFF. If I were redesigning the system, I would look at it analytically as three lines: One as systemic risk regulator; second, a consumer protection agency, which is the SEC and CFTC, which would have enhanced regulation over financial disclosure, and third, consumer financial disclosure.

Chairman LIEBERMAN. You would put them together?

Mr. DAVIDOFF. I would have two separate agencies. I would put the CFTC and SEC together.

Chairman LIEBERMAN. That is what I meant.

Mr. DAVIDOFF. It creates opportunities for regulatory arbitrage. There is really no good reason to have them separate anymore. Some people argue they should be competitors, they are models, but we have ample models and competitors abroad globally that can regulate them.

I think there is a third type of regulator, which Professor Jackson alluded to, which is your capital regulator, which is your FDIC or the Office of the Comptroller of the Currancy (OCC). And so there are really three lines: Your lender of last resort systemic regulator, then capital regulator——

Chairman LIEBERMAN. Which would be the Federal Reserve.

Mr. DAVIDOFF. Well, you can place them wherever you want.

Chairman LIEBERMAN. Yes.

Mr. DAVIDOFF. And I think Professor Jackson makes a good point, which is the Federal Reserve is naturally cited as the lender of last resort, but it is a unique independent agency. And perhaps the capital requirements should be elsewhere with Federal Reserve input because we want congressional oversight. And this is why it is good that your Committee is having this hearing because it is really a structural issue. Congress should not be legislating the nuances, or else you are going to get into a battle of the experts in deciding things. You should set up a regulatory apparatus and let those regulators fill it all in.

Chairman LIEBERMAN. Great. Thank you. Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman. Let me take up where you left off.

As I look at this issue, it is clear that we have a gap because there is no one who is responsible for assessing systemic risk, what Professor Jackson called the "market stability regulator." So that is a problem. And it is interesting. A few years ago, the House actually rejected regulatory authority over Freddie and Fannie that would have allowed regulation for systemic risk. When I look back

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on that with the benefit of hindsight, it is just extraordinary that the amendment was defeated so handily in the House.

But then there is also what I call the safety and soundness regulators from my experience at the State level. We would not allow a State-chartered bank or credit union to have a leverage ratio of 30:1 that Bear Stearns did. That is just inconceivable. So you need that safety and soundness regulator to be extended so that a large investment bank has to meet the same kind of capital requirements and undergoes the same kind of audits and reviews as the local credit union—whose failure would be far less devastating for the economy.

And then the third issue to me is who ensures that new, exotic financial instruments like credit default swaps do not fall through the regulatory gaps. To me, credit default swaps are an insurance product, and yet they were not regulated as insurance. They also were not regulated as securities.

So help me sort through who should do what, and I am going to start with you, Professor Jackson, because you started down that road when you said the Federal Reserve Board should have the systemic risk authority.

Mr. JACKSON. Right. Well, I do think this would fall into the second heading of my discussions, I think, in terms of thinking about how you are defining jurisdiction. This is a lawyer's task, writing the jurisdiction of agencies, and it can be done in a lot of different ways. We have tended to take a narrow focus, so the SEC has authority over securities. It is a defined term. The Supreme Court has decided I think maybe 15 cases at this point about what that term means. There was litigation about whether swaps were securities in the 1980s and 1990s, and they were determined to fall outside of the SEC's mandate for the most part, and Congress did not reverse it. It sort of validated that decision.

So I think that whether it is the SEC or a consolidated supervisor, one should define the jurisdiction broadly, and so, for example, you could define the jurisdiction to be over products that are financial in nature. That is a definition we use in some areas, which is an open-ended definition that gives the agency authority to say if a new product comes along, that is financial, and we are going to exert some sort of jurisdiction.

To pick up on a question that Senator Lieberman put forward, I do think that the agencies have to have the power, if a new product comes along, to say this is financial and you just cannot sell it willy-nilly any way you want. You can sell it but it has got to be, for example, on an exchange with a clearing and settlement system that we can keep track of, so we know the transparency, so we know counterparty risk. And that does mean saying you cannot just go to London and do it on Fleet Street any way you want because we recognize that increases risk.

So I think the regulators have got to have the self-confidence and the support to say certain products are too risky. For too long we have said, well, as long as it is institutional investors, we do not need to worry, they can fend for themselves. The lesson of the last year is when institutional investors get into trouble, sometimes they drag the rest of us down, and we need to have just a different philosophy that sometimes means saying no.

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Senator COLLINS. Professor Davidoff.

Mr. DAVIDOFF. I agree with that sentiment. If you do not have regulators with broad jurisdictional authority, you will have Ph.D.'s on Wall Street who will structure products to fill that black hole. And so you need regulators with broad authority, and you need it over the entire financial system. Credit default swaps are a perfect example. They are traded over the counter. We have no idea who the parties are. They should be traded on an exchange, or a regulator should look at them to see if they should be traded on an exchange.

But we have to regulate forward, not backward. We do not know what the next crisis is going to be. So we need to have regulators that have full jurisdictional scope.

Senator COLLINS. Should we have safety and soundness regulation for entities like the Bear Stearnses of the world?

Mr. DAVIDOFF. Absolutely. I mean, the investment banks, the only reason the CSE program existed was because the investment banks needed a regulator under an EU directive.

Senator COLLINS. But that was a voluntary program.

Mr. DAVIDOFF. Right, it was a voluntary program that they were trying to get out of direct oversight from the European Union, and they existed in this netherworld of unregulated jurisdiction.

Now, the elephant in the room, which we have alluded to, is insurance. It is regulated by the States. It is a big problem, how we capture those products, because if we regulate all securities, if we have oversight of hedge funds—and here I am talking about oversight, not necessarily regulation—the regulator should have the power to regulate. But that should be done through the regulatory process. But if we leave, for example, insurance out of the mix, what do we do then?

Senator COLLINS. Mr. Dodaro, who should be the regulator for what? Who should be the systemic risk regulator? Should safety and soundness regulation by front-line regulators be extended to all financial entities that could possibly pose hazards to the economy?

Mr. DODARO. Our report at this juncture does not make specific recommendations, but the points that you are probing on go to a couple of the characteristics that we have. One is the systemwide risk proponent that would look across the system and look for systemic issues. I think also, Senator Collins, that ensuring that regulation is comprehensive, is one of the characteristics that is meant to close the gaps with entities and products.

Then the third component that we point out has to do with flexibility and adaptability, and I completely agree with my colleagues at the witness table here that we need a proactive approach and not a reactive approach. And I think that is where you are headed with your question, and I quite agree with that, whoever that person is who is charged.

But it also goes back to our first objective and characteristic in our framework, which is to set clear regulatory goals and mandates and charter and give the regulators the broad authority, then hold them accountable for doing it.

Senator COLLINS. Thank you.

Chairman LIEBERMAN. Thanks very much, Senator Collins. Senator Levin.

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Senator LEVIN. Thank you, Mr. Chairman.

Let me do something which really is not the direct purpose of the hearing, but something that I want to do to take advantage of your expertise while you are here. It is obvious from your answers that you do have some opinions on not just who should do the regulation, but whether certain activities ought to be regulated. I do not know whether, Mr. Dodaro, you are going to want to or be able to comment, but let me start with our other two witnesses.

First, should hedge funds be regulated? Professor Jackson.

Mr. JACKSON. Yes

Senator LEVIN. Professor Davidoff.

Mr. DAVIDOFF. Yes.

Senator LEVIN. Are they currently regulated?

Mr. JACKSON. I would say inadequately. I think this is a good example that the SEC had an initiative to bring the advisers under their jurisdiction. Whether that is strong enough for all aspects of their activities, I am not sure. But that was certainly an important first step.

I think beyond thinking about the hedge funds as entities, it is the products—the credit default swaps, the OTC products—that need to be brought into what I think would look more like a futures regulation standard.

I would say here that I think this is just an excellent area to rethink how we got into the current situation of the CFTC and the SEC being in competition for business and trying to attract entities by giving exemptions that play to our disadvantage over the long run.

Senator LEVIN. I will get to the specifics of the hedge funds.

Mr. DAVIDOFF. Can I just add something on the hedge funds?

Senator LEVIN. Yes.

Mr. DAVIDOFF. I think if you ask someone, if you ask a regulator what role did hedge funds play in the current financial crisis, I think he would look at you like a deer in the headlights because we just do not know. And one of the things that we need—and even the hedge fund managers who testified about a month ago agree—is an oversight process for hedge funds, and we need a disclosure process. It may need to be confidential. But there are also systemic risks of unregulated capital pools that any systemic risk regulator will have to look at. Even the Harvard Endowment is in some terms a hedge fund, and we need to bring those capital pools under some oversight, or else the next systemic risk will rise there. And it happened in Long Term Capital Management. It could happen again.

Senator LEVIN. Let me move to the credit default swaps. We have had a lot of discussion about that. The SEC Chairman, Christopher Cox, back in October asked for jurisdiction over those credit default swaps. Professor Jackson, should they be regulated?

Mr. JACKSON. Yes. I think that Mr. Cox's proposal was a good one, albeit a piecemeal response, but that would be an incremental improvement, his recommendation.

Senator LEVIN. Mr. Davidoff.

Mr. DAVIDOFF. Yes, I think they should be moved to an open exchange.

Senator LEVIN. Where they would be regulated.

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Mr. DAVIDOFF. Yes, where they would be regulated. That way we can see the pricing, and the price discovery mechanism can work. And if credit default swaps are going up on an entity, we can see it instead of an opaque process.

Senator LEVIN. Senator Collins has, I believe—or last session, at least—introduced a bill on this, and I fully support that effort. But the bottom line is the two of you believe that Congress should eliminate the barriers to the regulation of credit default swaps.

Mr. JACKSON. Yes.

Mr. DAVIDOFF. Yes.

Senator LEVIN. By the way, Mr. Dodaro, if you have a feeling of any of this, if this is within your ambit, just jump in anytime.

Mr. DODARO. Well, I will get caught up quickly.

First, on all of these areas, our belief is you definitely need more transparency. I agree with my other witnesses that whoever the systemic risk regulator is should have some jurisdiction over these issues. And, Senator, I would point out that we have raised concerns about some of these derivative products dating back as far as 1994. GAO encourages that some of the regulators have oversight over these derivative products.

Senator LEVIN. All right. I want to keep going down a rat-a-tat-tat list here, if I can, because I think this is important while we have your expertise here. Now, we were talking about credit default swaps. What about Federal regulation of all types of swaps, including interest rate, equity, and foreign currency swaps? Same answer or different answer? Professor Jackson.

Mr. JACKSON. Well, I think that you need to look at some of these products on a case-by-case basis, but I think that you need to have a single financial authority who is making a decision about the best way to approach these instruments. In some cases, it may not be necessary to go to exchange-based regulation. One may want to do it by regulating the entities that engage in the transactions. But I do not think we should have an artificial boundary or a competition between agencies around these instruments. I think they should be fully within the financial sector and an expert agency should have the jurisdiction.

Senator LEVIN. There ought to be jurisdiction in an agency to regulate.

Mr. JACKSON. To regulate.

Senator LEVIN. Fair enough. Professor Davidoff.

Mr. DAVIDOFF. Absolutely you need the ability.

Senator LEVIN. All right. And the authority in an agency to regulate.

Mr. DAVIDOFF. Yes.

Senator LEVIN. Now, what about over-the-counter market derivatives?

Mr. JACKSON. I would give the same answer to that.

Senator LEVIN. Same answer, Professor Davidoff, or different?

Mr. DAVIDOFF. The same answer. You need jurisdiction over everything.

Senator LEVIN. Capital reserve requirements on banks and security firms—should Congress require regulators to impose stronger capital reserve requirements? Should we just simply authorize them to do it?

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Mr. JACKSON. I think that Congress needs to be careful not to be too specific in its dictates, only that if you are too specific the industry will work around it. I think that comprehensive capital requirements are important, and it needs to be done not just at banks and insurance companies, but it needs to be done for conglomerates as well, including the entities that we do not have traditional names for.

So I think one needs to be careful about specifying sector regulations as opposed to saying we need to have a comprehensive oversight of solvency and liquidity.

Senator LEVIN. Authorize an agency to do that.

Mr. JACKSON. Authorize an agency, and then——

Senator LEVIN. That is fine. That is in keeping with your previous answer, essentially.

Mr. JACKSON. Yes.

Senator LEVIN. Professor Davidoff. I know this may sound obvious to you, but let me tell you, we have to build up a record if we are going to move quickly on this thing. I think all of us want to get to the structural issues, and again, I commend our Chairman and Ranking Member. This is a tough job to do that. It is a harder job in a lot of ways because it is more technical. It does not have the glamour of some of these other issues, so-called.

Senator BURRIS. It does not have the sex appeal.

Senator LEVIN. Sex appeal, there you go. It is essential that it be done, but we cannot let that effort stop us from doing things we have to move very quickly on. So that is why I wanted this record to——

Mr. DAVIDOFF. Can I just add one more thing here——

Senator LEVIN. Of course.

Mr. DAVIDOFF [continuing]. To your very good point, which is Congress should use its political capital to set up a structure, and they should not get bogged down in the details. Sometimes they should, but bank capital requirements is a fight that Congress does not need to pick. They can have the regulator have the authority and give them the authority to set it.

Senator LEVIN. But it is clear that we ought to act to give the regulators those kinds of authorities?

Mr. DAVIDOFF. Yes.

Senator LEVIN. My time is up. I have some additional questions, Mr. Chairman, for the record along the same line, and I very much appreciate the patience of our witnesses because this is really slightly different than what they were called to testify on, which is very valuable testimony. But I want to thank you for your testimony.

Chairman LIEBERMAN. Thanks, Senator Levin. I agree with you. To go back to a metaphor you used in your opening statement, which is used a lot but it is very relevant here, and your last series of questions made the point, which is: There are a lot of financial beats in America today that do not have a cop on them, and that is part of the reason why we are in the mess we are in now.

The second thing is that the public gets this, and they are really infuriated, and it does create a political moment in which we can achieve the kind of comprehensive, proactive reform in regulation of financial entities for which you have all in one way or another

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called. So, obviously, at some political moments you can overreact. This happens to be a political moment, I think, where the public wants us to do, in fact, what we should do. And you are testifying from a very non-political point of view that is exactly the case.

Senator LEVIN. If I could just interrupt for one more second. We had the SEC months ago asking us for authority to regulate credit default swaps.

Chairman LIEBERMAN. Yes.

Senator LEVIN. Now, it should not take much, as far as I am concerned, to do that little piece as quickly as we can. We are talking—I do not know—$1 trillion?

Mr. DAVIDOFF. Twenty trillion dollars.

Senator LEVIN. Twenty trillion dollars of exposure?

Chairman LIEBERMAN. Here is an interesting number. From June 2006 until June 2008, the market value of outstanding credit default swaps increased from $294 billion to $3.1 trillion. So in just 2 years, it went up tenfold. That is a lot of money, even around here. You agree.

Senator LEVIN. Thank you.

Chairman LIEBERMAN. Thank you. Senator Tester is next. For Senator Burris' information, we have a rule on this Committee that we call on the Senators in the order of arrival, so you will be next after Senator Tester.

OPENING STATEMENT OF SENATOR TESTER

Senator TESTER. Thank you, Mr. Chairman, and I, too, appreciate the hearing that you and the Ranking Member have lined up here. I do not know how many Members of this Committee are also on the Banking Committee. I am one. Senator Carper was one also. I do not think he is on it anymore. And I do not mean to speak for the chairman of the Banking Committee. You know him better than I do. But I would say that any suggestions this Committee could give to the Banking Committee would be well accepted. This is a very complex issue. And as you pointed out, it is an issue that I think the public wants something done here to re-establish faith in the marketplace.

Chairman LIEBERMAN. Thanks, Senator Tester. I forgot that you were on the Banking Committee. I did talk to Senator Dodd about the hearing, and he was encouraging. And, obviously, we defer to you in terms of legislation, but maybe this Committee can offer some suggestions about what form that should take.

Senator TESTER. We would be more than happy to take them forward and would be more than happy to hear suggestions even on a personal basis, because like I said, it is complex.

I guess the question I would have for all three of you—you understand how complex the markets are, and you already talked about the holes and the overlaps and the fact that it does not work very well right now. How much time do you think, if we really got after it, would it take to develop a structure that would be comprehensive enough to add consumer confidence to the marketplace, but yet not so detailed that we have to fight fights we did not have to fight, and not so regulatory that it would take away flexibility in the system and deter growth? Just give me an idea on how long you think that would take to do something that would be thorough.

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Mr. JACKSON. Well, I think that is a good question, and the way I think about it is on two levels. For Congress and the new Administration to come to a consensus about the direction that we should go in, whether it should be the two-peak model that I was outlining or a three-peak model that Professor Davidoff was suggesting, or a more narrow set of consolidations with a different agenda, I think that is something that could be decided in this session relatively quickly.

I think that the task of implementing is one that you need to give a lot of thought to. Just as an example, in the United Kingdom there was a 3 to 4 year process from when the Blair government decided it was going to consolidate its supervision—it created a shell entity that carried the baggage, but the legislation took 3 years to enact. And, actually, they created the agency first, and it had the task of helping draft its own legislation. So I think the more you go to a really comprehensive solution, the more you are going to need to draw on expertise for this very technical task.

One example, something that came up here that we did not mention in our testimony, is dealing with financial institution failures. Right now one of the problems, one of the reasons things are too big to fail is that we do not have a mechanism for wrapping up big institutions because we have the banks, the securities companies, the insurance companies, and the Federal Bankruptcy Code all interacting.

Well, we should have a consolidated disposition process so when Lehman goes bankrupt, we can actually deal with it. And then we actually could make it fail because we would have a mechanism.

Senator TESTER. So you are saying several years.

Mr. JACKSON. Several years, yes.

Senator TESTER. Mr. Davidoff.

Mr. DAVIDOFF. I think I agree with that assessment. But I think that Congress can pass a bill that does it this session.

Senator TESTER. Mr. Dodaro.

Mr. DODARO. I think that part of it depends on a couple factors: One, that Congress required the Congressional Oversight Panel under TARP to submit a regulatory reform proposal; and also required the Secretary of Treasury to have a proposal. There have been a couple that have come forward from other sources, and to the extent to which there is a consensus gathering on some of those issues I think is important. But I think it is going to take time to do it right and to do it comprehensively.

Senator TESTER. Well, let me ask you this, then: If it takes that kind of time, do you think that there is any threat that—and I mean that just as it sounds—a regulatory system from outside this country could actually become the standard by which we live, from the European Union or Pacific Rim?

Mr. DAVIDOFF. I think the answer to that is no. I mean, they are equally as troubled, and capital flows, although they can shift rapidly, are staying concentrated in the United States due to our——

Senator TESTER. Do you see it the same, all of you? How about you, Mr. Jackson? You understand the question?

Mr. JACKSON. No, I do not. Can you just repeat what the question is?

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Senator TESTER. What I am concerned about is that our regulatory system is screwed up right now, to be kind. The financial crisis is a worldwide situation, and if our reform is not done in a reasonable amount of time, would we have to live under the rules of another system—the European Union's financial system or the Pacific Rim's or however you want to put it? Do you see what I am saying? If ours is inadequate, does that mean we have to take theirs? Does that mean the companies, the investors, and all of the above adopt theirs?

Mr. JACKSON. Well, I think that, as Professor Davidoff says, the companies will stay in the United States because there is so much business in the United States, and they are going to be here, and they will live with our rules.

I think that we can learn from other jurisdictions, and I think we can have a more effective and cost-effective regulatory system if we move to consolidation, which is what is done around the world.

Senator TESTER. I would agree with you.

Mr. JACKSON. But we control our regulatory fate.

Senator TESTER. Good. That is all I need to know. Mr. Dodaro, do you see it the same way?

Mr. DODARO. Basically.

Senator TESTER. Perfect. I have got a question, because it has been brought up a few times. My mother brought it up to me a while back, and it is something that we bounce off and around once in a while. We are 10 years after the Gramm-Leach-Bliley Act, which means we are also 10 years after the undoing of the Glass-Steagall Act. If the Glass-Steagall Act had still been in effect, do you think this same problem would have happened?

Mr. JACKSON. I am fairly confident the same problem would have happened. The securitization process was already underway, and we did not need Gramm-Leach-Bliley to facilitate that.

Mr. DAVIDOFF. I think it exacerbated it. The banks and the investment banks began competing with each other, and the investment banks were not built to compete in that way.

Senator TESTER. So you are saying the Gramm-Leach-Bliley Act exacerbated it.

Mr. DAVIDOFF. Yes.

Mr. DODARO. I think the question is more what was not done rather than what was done. And I think the necessary adjustments were not made to the regulatory structure to follow the policy decisions and what was going to occur in the market.

Senator TESTER. Thank you, Mr. Chairman. I, too, would like to welcome Senator Burris to the Committee. I am sure that his opinions and perspectives will be much valued.

Chairman LIEBERMAN. Thanks, Senator Tester. Again, I am really happy that you are on the Banking Committee, and that gives us a good link to the work of that committee.

Senator Burris, it is really a great honor—having met you before you came to the Senate, knowing of your service in Illinois, particularly the time as Attorney General, but obviously you have done a lot beyond that—to call on you for the first time to question the witnesses. Senator Burris of Illinois.

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OPENING STATEMENT OF SENATOR BURRIS

Senator BURRIS. Thank you, Mr. Chairman. By the way, Mr. Chairman, I am also an old banker. I started out my career as the first black in this Nation to be a bank examiner for the Comptroller of the Currency, and I am sitting here just taking all this in.

Chairman LIEBERMAN. That is great.

Senator BURRIS. And I have a couple of questions I would like to ask.

One, have we really listed the various agencies? We have the FDIC. We have the SEC. How many agencies are involved that would be impacted by any type of regulations? And would we have to then seek to come up with some type of blanket or overall package that would impact each one of these agencies that has these piecemeal jurisdictions over all of these various entities? How many are there? You also try to get the Comptroller of the——

Mr. DAVIDOFF. In the GAO report, they have nine, I believe, primary agencies. Which would be 10 if you included the Treasury. But I would ask that they confirm that.

Mr. DODARO. Yes, there would be 10 with the Treasury, and I think your question is appropriate, both in designing the reform that would be put in place, but also making the transition as——

Senator BURRIS. As to try to tie all those together and get all of those different interests that are going to be protecting their turf and all the other types of situations that could cause a problem. Professor Jackson.

Mr. JACKSON. I think that there actually are some that the GAO report may not have included. I would include the Department of Labor with respect to Employee Retirement Income Security Act (ERISA) issues. I would include HUD with respect to mortgage lending. You could say that the most important financial agency for most people is the Social Security Administration with its retirement savings program.

So there are a host of little pockets around government in addition to the primary agencies that one should think about collectively. But it is a large number.

Mr. DAVIDOFF. I would add that I do not expect that everything will be cleaned up into a neat package. I would recommend you build dominant regulators, whether you adopt a twin-peaks model, the three-peaks model, and have them over time—have their primary goal so they can absorb these functions.

Senator BURRIS. And one other point that may seem a little bit farfetched, but I have to take my mind to the ultimate of all this, and that is the consumer and how would that consumer get impacted by this overall change in regulations. It was the consumer that ended up getting all caught up in these various different piecemeal approaches as the subprime lending, and then not only subprime but prime, got caught up in these equity loans and dropping house values. So that also impacted what happened in our financial markets because there are a lot of individuals who are not subprime who were just underwater. Their mortgages exceed the overall value of the property that they are living in, and that constant pressure of equity, take out the equity because it is not going to go down, and we found ourselves in serious trouble.

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The consumer has to be taken into consideration of how these regulations are going to impact them, and I just hope that we would give some thought to just how that person would ultimately be impacted by that.

Mr. JACKSON. Senator, one of the problems, as I see it, is that each of our agencies has a consumer protection division or a division of consumer affairs, but it takes a second seat to other functions at the Federal Reserve or at the OCC or the other agencies. And what we need to do is increase the salience and the importance of the consumer protection function, and that can be done with an accountability standard. It can be done in a consolidated agency by having a division of consumer affairs, perhaps with a political appointee and Senate confirmation to elevate the status. Or it could be done with a specialized market conduct regulator that has consumer protection as a mandate.

But I think it starts with Congress saying that this is a major goal and setting up a structure that someone has that as their main mission, not as a secondary or tertiary mission, which tends to be what is going on nowadays.

Senator BURRIS. Thank you very much.

Mr. DODARO. Senator, I completely agree with that, and that is one of the main characteristics that we point out that should be in the framework of crafting and evaluating proposals to reform the structure. Also, the States play a very important role here, as I am sure you are aware, based on your past position.

Senator BURRIS. I am a former State Comptroller.

Mr. DODARO. And I do think that whatever is done ought to be to preserve and to build on that check and balance at the State level.

Mr. DAVIDOFF. And, again, I would just add a small point, which is it should have broad jurisdiction. So it is not just mortgage disclosure. It is credit card disclosure. It is financial protection for consumer financial products.

Senator BURRIS. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you very much, Senator Burris. I appreciate that. Your question was an interesting one, and if you add on the State agencies that really do get involved, you could get pretty rapidly up to about 200 separate oversight—we have some ability, but we do not want to overdo it to deal with the State agencies as well and allocate authority. But it really is a fragmented system, and it does leave a lot of gaps, which give people room to play games in between.

Senator BURRIS. Mr. Chairman, they mentioned one industry that really needs to be looked at, and that is the insurance industry.

Chairman LIEBERMAN. Yes, sir.

Senator BURRIS. We really have to check out the insurance industry.

Chairman LIEBERMAN. Thank you. I look forward to working with you on the Committee.

We will do a second round for any of the Senators who want to ask additional questions.

Professor Davidoff, I want to ask you one thing briefly, which is, in your testimony, interestingly, you mentioned that the lack of co-

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ordination between some of the existing regulatory agencies—in the case you particularly mentioned the FDIC, the Treasury, and the Federal Reserve—may actually have contributed to the ad hoc and ultimately inadequate nature of the government's response to the current fiscal crisis. So the fragmentation in the system may not only create gaps that allow for the problems, but it also creates a problem in responding to a crisis or a scandal. Correct?

Mr. DAVIDOFF. Correct. Obviously, I was not in the discussions, but from news reports it is clear that the regulators conflicted over what to do at certain times, and they lacked the full authority to address the crisis. And these bailouts, one reason why they are so haphazard is because they were structured within narrower limits of the law than they were subject to.

Chairman LIEBERMAN. I believe Mr. Dodaro first and then others mentioned the ideal or the goal that we may, as part of our reform, want to create a system in which the financial entities are asked to bear the cost of the risk. Just conceptually—the canvas is empty now and we are thinking about how to paint on it—what kind of system would that involve? Would it be fees up front?

Mr. DODARO. Well, basically you would have to have some kind of fee structure. It would basically take the Bank Insurance Fund concept that is in place and replicate that or adapt it—is probably a better word—to the other types of services and products. This goes, too, to how the regulators should be funded to preserve their independence. So I think it is both a system that needs to be put in place modeled after the Bank Insurance Fund, conceptually, that would require that some fees be paid into a centralized fund that could then provide for the industry that is in need of it, but also have it be funded in a way where the regulators have clear independence. Right now they are funded in different schemes, which contribute to some of this difficulty in deciding how to hold people accountable.

Chairman LIEBERMAN. We have been reminded in the Bernie Madoff case that there is a fund there that can be drawn on to a limited degree to try to compensate people who were cheated by Mr. Madoff. But I presume that there are large areas of financial transactions where there is no such fund and, therefore, there is no coverage for loss. Correct, Professor Jackson?

Mr. JACKSON. There is a complicated system of specific guarantees. It is limited given the losses in the Madoff case, but it is available for fraud of the sort that he engaged in apparently. And there is the FDIC fund for banks, there are State guarantee funds operated at the State level for insurance companies to protect individuals when institutions fail.

I think the model for a systemic recovery would be the FDIC Improvements Act of 1991 (FDICIA), which basically says that if the FDIC saves a bank that is too big to fail and takes on extra costs, those extra costs are then charged back to the whole banking sector over some period of time. And TARP has that characteristic, too. There is a provision that says if TARP loses money—which it seems like it will—then in 5 years, the Treasury has to make a recommendation for a charge-back. So that is the kind of mechanism on the systemic risk side.

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I think for ordinary failures, the pre-funding model, which Mr. Dodaro referred to, is the sensible one. The FDIC fund is kept at a certain percentage of deposits, so that handles routine failures. But then when there is a special failure, you need to have some special mechanism. And it should be consistent throughout the financial services industry, and it is not right now. If the Federal Reserve loses money on some of its interventions, there is no mechanism to get recovery and there is no general system for chargebacks that I think would be important to put in place.

Chairman LIEBERMAN. Would you like to add anything to this discussion?

Mr. DAVIDOFF. No. I think it has been adequately addressed.

Chairman LIEBERMAN. Good enough. Let me, since we are painting on a big canvas that is, obviously I would like to think, not filled now—as we reconsider where we are—we are dealing here in so many cases with an extraordinarily different international financial system where enormous sums of money travel with incredible rapidity, and one of you mentioned, using it for another point, how frustrated European regulators, or the British, are sometimes when they come here because they have to shop around or figure out who to talk to.

This may be reaching a bit beyond, but in response to the current crisis—last year I remember reading that there was a town in Norway that was going under financially because it had put its money in mortgage-backed securities that were failing.

Senator BURRIS. And Iceland.

Chairman LIEBERMAN. And Iceland, exactly. So should the United States be initiating some round of international discussions now to create either new international entities for financial regulation or institutionalizing or regularizing some kind of interaction between national regulators?

Mr. JACKSON. Well, I mentioned the international connections, and I do think it is increasingly important for us to have coordination and cooperation, particularly with our leading economic allies. I think the tenor of today's discussion of having more regulation, tightening the regulation, is entirely appropriate. But it means that the pressure to move offshore is going to be strong.

Chairman LIEBERMAN. Right.

Mr. JACKSON. And there are two places people can move offshore. They are to the developed countries—Europe, Asia, and major markets—where we can and should have good coordination. I think the task of absolute harmonization is not an appropriate aspiration because their systems are different, their traditions are different. But we need to have convergence and coordination with these major entities. Then we need to collectively deal with the second group of entities, which are the offshore centers that we can only deal with collectively. And we have had some good experience internationally cooperating on that, but we need to be working with our allies to protect all of us against the offshore centers. So that is a priority.

Chairman LIEBERMAN. Mr. Dodaro or Mr. Davidoff, any response to our international responsibilities?

Mr. DODARO. Well, I think there are two things at a minimum. One is there have been some international bodies of individuals from the different countries that have had some dialogues, and I

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know this was mentioned to me when I was in the United Kingdom talking to one of their treasury officials. And so there are proposals both to perhaps more institutionalize this, expand this type of regular discussion and dialogue on issues. Second, there should be some discussions looking at international organizations, like the International Monetary Fund and others, that could perhaps play an enhanced role in this.

I am not positing any particular outcomes, but I do think international dialogue is very important as part of the equation in this particular issue.

Mr. DAVIDOFF. I would just add that I think there is already an extraordinary amount of dialogue between regulators, and the Federal Reserve, in fact, entered into a dollar loan program with the other banks in Europe because of their difficulties.

I think that the issue is that although dialogue is good, we have to take a stand on some regulation and say this is where we will go, and because someone else does it differently does not mean that we have to set it there.

Now, that should be done with the regulatory process, and we need to keep the preeminence of the U.S. capital markets, and the best way to do that is through treaties and cooperation but also by saying you are not going to be able to come into our system, which is the largest system, if you don't play by our rules.

Chairman LIEBERMAN. Excellent. Thanks. Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman.

Professor Davidoff, I want to talk further with you about the "too big to fail" issue, which the Chairman raised at one point. It concerns me that we are creating a classic moral hazard. If we send the signal—and, indeed, we are sending the signal—that if you are big enough so that there are consequences to the economy in terms of job losses or other cascading effects that we are not going to allow you to fail, we take away any incentive to carefully manage risk.

In addition, we encourage companies to become bigger and bigger or to enter into financial arrangements where there are more complex and interlocking transactions to make these institutions' failure too consequential for our economy.

How do we prevent that? I know that is not an easy question, but I am really concerned that we are sending a message to just become bigger and bigger, riskier and riskier, and don't worry, Uncle Sam will bail you out?

Mr. DAVIDOFF. This is a hard one. Let me give you just a quick anecdote. When Lehman failed, it defaulted on its commercial paper, which was held by the money market funds, including Prime Reserve, which broke the buck. In the space of 48 hours, over $200 billion was taken out of money market funds. Money market funds, if they do not have money, can't buy commercial paper. Most of industrial America finances its operations through commercial paper. Literally, the cash machines almost shut down. Because Lehman defaulted on its commercial paper, the money market funds were losing all their funds and couldn't fund the commercial paper market. Companies couldn't get their commercial paper, and they were unable in that market to get their financing. And that just shows how tightly interconnected the world is today.

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I think what you do—and I look forward to a vigorous debate and the other experts offering their opinions—is two things. First, ironically we have been building big institutions through this process. You need to manage those institutions. And, second, I think this has been such an extreme event that the moral hazard effects may be reduced. But we need to put in incentives for the people who are trading and running these institutions that they will be penalized.

I hate to jump into the executive compensation arena—and we certainly shouldn't, in doing regulatory reform—but you need incentives that people will be punished. They can't leave with a $1 million exit package. If their institutions fail, they should leave with nothing, including without their country club membership.

Senator COLLINS. Professor Jackson, I would like you to address this as well, but I also want you to address a related issue. When I look at the financial markets—and it is related to the problem I have just outlined—an issue at risk is divorced from responsibility at every step along the way. It used to be that your community bank made the loan, kept the loan, so if the loan went bad, that institution bore the consequences. Now, the mortgage broker may make the loan and take his fee. He does not care what happens to the loan after that. Then it goes on to the financial institution, which takes its fee. Then it is sold on the secondary market. Everybody is getting a cut along the way. Then when the mortgage is sliced and diced and securitized, it means that nobody is really bearing the risk of the decisions that were made. And yet everybody is taking a cut and getting paid along the way.

Mr. JACKSON. Right.

Senator COLLINS. And I don't know what we do about this.

Mr. JACKSON. Well, this has definitely been a problem. You describe the nature of the huge moral hazard agency problem that the mortgage financing system has generated.

One thing that I will say going forward is if we look at the system backwards and we think of that pension fund up in Norway that ended up holding mortgage paper, it is going to be a lot more careful the next time it buys American securities, if it ever does.

So I think we can expect some pretty severe market corrections, and one of the ironies is we are living in a market over-reaction. No one wants to finance mortgages anymore, which is part of our problem that we are currently in.

So some of the correction is going to come from people who have been burnt who are going to be more careful. We clearly need to look at these relationships and decide when there is not enough skin in the game and whether we want to have a mortgage brokerage industry operating the way it has in the past. I am quite dubious anyone will ever buy mortgages from the old mortgage broker system. But we need to look at those conflicts very carefully.

On too big to fail, one thing I would just like to say is it is important for groups like GAO to think hard about why institutions are too big to fail. And sometimes the reason is we have allowed them to enter into such complicated transactions and complicated networks that we can't unwind them. So I think AIG, Lehman, and Bear Stearns have this characteristic. The solution is make a better swap system with clearinghouses, and then if we had a good clearing system, we can let them fail.

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So you can prevent "too big to fail" by not having complex payment systems or complex clearing systems. So that is a prospective solution.

In the case of Fannie Mae and Freddie Mac, they are too big to fail because they had too large a share of the mortgage business, and we also let every bank in the country buy as much stock or bonds of Fannie and Freddie as they wanted. Now, that is a recipe for too big to fail.

If we are going to have government-sponsored enterprises (GSEs) in the future, which is an open question, we should make them smaller. We should not let their financial significance be so big so that if one of them needs to shut down we can't just shut it down.

So we can correct some aspects of too big to fail going forward. If we have a disposition mechanism that can handle liquidation in a sensible way, that will also give us more latitude.

So smart regulation can allow us to enforce market discipline, and I think that is an important lesson going forward.

Senator COLLINS. Thank you.

Mr. Chairman, I am going to have to leave, and I apologize that I will not hear the Senator's final round of questions, if he has some—he is done? Well. Could I just read for the record from Warren Buffett?

Chairman LIEBERMAN. Go right ahead.

Senator COLLINS. In 2002—he is not called "The Oracle" for nothing—he wrote to his shareholders, and he said, "We at Berkshire Hathaway try to be alert to any sort of mega-catastrophe risk, and that posture makes us unduly appreciative about the burgeoning quantities of long-term derivative contracts and the massive amount of uncollateralized receivables that are growing alongside."

Listen to this statement: "In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

How sad it is that when Warren Buffett said this in 2002 that the regulators apparently weren't listening.

Chairman LIEBERMAN. Amen. Thanks, Senator Collins.

Senator Burris, no further questions?

Senator BURRIS. No.

Chairman LIEBERMAN. Thanks so much. I appreciate it.

The three of you have been excellent witnesses and, again, I thank you, Mr. Dodaro, for the GAO report. You have really gotten us off to a good start here. We are quite serious about this. Actually, I think in talking to the Members, you have engaged our interest.

I wonder if I could presume on your service to the Committee thus far—this is a pleasure that a Senator gets in giving two law professors a homework assignment, so to speak, which is, I am really intrigued by the two-peak/three-peak model. I am not asking for a law journal article because I know you are very busy, but if you would for the benefit of the Committee, in writing, over the next couple of weeks just outline, with what we have now, how would you bring agencies together? How would you change things? I think it would be very helpful to us and to the Congress overall.

Mr. Dodaro, to the extent that you are able to do that within your mandate, we would, of course, really welcome the same from

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you. And we are glad to talk to you more about the best way we can do that.

Mr. DODARO. Yes, I would like to give that some thought, and we could have some follow-up dialogue.

Chairman LIEBERMAN. Good.

Mr. DODARO. And I would also like to recognize the fine efforts of the GAO team that put the report together.

Chairman LIEBERMAN. It is another excellent piece of work to assist Congress and in the public interest by GAO. I appreciate it.

We will keep the record of this hearing open for 15 days in case any of you want to submit additional testimony or any of the Members want to submit testimony or questions to you. But I can't thank you enough for bringing forth your expertise to help us prevent another crisis such as the one we are going through now.

With that, the hearing is adjourned.

[Whereupon, at 4:09 p.m., the Committee was adjourned.]

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WHERE WERE THE WATCHDOGS? SYSTEMIC RISK AND THE BREAKDOWN OF FINANCIAL GOVERNANCE

WEDNESDAY, MARCH 4, 2009

U.S. SENATE,
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 9:02 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, Tester, Burris, and Collins.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. Good morning and welcome.

Thanks for coming a bit early. As you know, we moved the hearing up so that we might attend the joint session to hear British Prime Minister Gordon Brown.

This is the second in our series of hearings examining the structure of our Nation's financial regulatory system in the aftermath of its obvious failure to protect us from the economic crisis that we are suffering through now. We are undertaking this series of hearings pursuant to Senate rules that give our Committee the responsibility for "the organization and reorganization of the Executive Branch of the government" as well as for the study of "the efficiency, economy and effectiveness of all agencies and departments of the government."

By examining what changes should be made to improve and modernize the organization of the Federal regulatory system, we are not only fulfilling these responsibilities, but we hope to be preparing ourselves to make recommendations to our colleagues on the Senate Banking Committee about reforms that they may be considering reporting out to deal with gaps in our financial regulatory system.

In other words, we see our unique role here as reaching a judgment about the structures through which we are regulating financial institutions, and not so much about the day to day regulations. This is particularly important based on what we heard at our first hearing from the witnesses, which was that our Nation's outdated and fragmented system of financial regulation is unable to handle risks that occur across many different types of institutions, markets, and activities.

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Today's hearing will examine the pros and cons of creating a systemic risk regulator for the financial services industry.

The first obvious question is what is a systemic risk regulator?

I gather that it means a risk that a failed institution, a risky activity, or a particular event could broadly affect the financial system rather than just one institution or activity. And, frankly, I want our witnesses to help educate me about the difference between that systemic risk regulating function and the other problem that we heard about at the last hearing, which is that there are, today, gaps in our regulatory system that leave trillions of dollars of economic activity unregulated.

The fact is that there is no one government agency or market participant responsible for monitoring systemic risks to the integrity of our entire financial system, and that is a significant fact.

Many experts believe that the gap should be bridged by creation of what we are calling a systemic risk regulator who would supervise or which would supervise the financial system holistically. Federal Reserve Chairman Ben Bernanke has given us another title to chew over. He has referred to such an entity as a macroprudential regulator. And I will wait for the three of you to help me understand that.

Part of the reason our current watch dogs failed, we learned at the last hearing, is because each has just a piece of the system to oversee. That, as I said a moment ago, leaves gaps.

For as long as there have been markets, obviously, there have been speculative bubbles and resulting financial crises. But through sensible regulation, I believe we can improve the ability of our financial system to prevent and withstand such shocks, reduce vulnerability to extreme crises and limit the damage to our economy when a crisis occurs.

And so, we come to this hearing with a series of questions and an excellent group of witnesses, questions like: Can the role of monitoring and responding to systemic risks be accomplished by expanding the authority of one or more existing regulatory institutions or should Congress create a totally new entity to act as a systemic risk regulator?

What would be the responsibilities of that body?

What tools would it need to meet those responsibilities?

And what would its relationship be with other regulators?

We have an excellent panel of witnesses before us today, and I look forward to their testimony.

Senator Collins.

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Today, as the Chairman has indicated, our Committee is examining the need to establish a systemic risk monitor that might have helped to prevent the financial crisis that our Nation now confronts, and I will stick with the term systemic risk monitor rather than macro-prudential regulator.

America's financial crisis has spread from Wall Street to Main Street, affecting the livelihoods of people all across the country. The American people deserve the protection of a new regulatory system that modernizes regulatory agencies, sets safety and sound-

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ness requirements for financial institutions to prevent excessive risk-taking and improves oversight, accountability and transparency.

Our financial regulators should have had the ability to see the current collapse coming and to act quickly to prevent or mitigate its impacts. Unfortunately, oversight gaps in our existing system, risky financial instruments with little or no regulatory oversight and a lack of attention to systemic risk undermined our financial markets. When the entire financial sector gambled on the rise of the housing market, no single regulator could see that everyone from mortgage brokers to credit default swap traders was betting on a bubble that was about to burst. Instead, each agency viewed its regulated market through a narrow tunnel, missing the total risk that permeated our financial markets.

When the housing market collapsed, the impact set off a wave of consequences. Borrowers could no longer refinance their mortgages. Credit markets were frozen. Consumer demand plummeted. Businesses were unable to make payments or to meet payrolls. And workers were laid off, making it even more difficult for families to pay their mortgages.

In Maine, the unemployment rate has reached a 16-year high of 7 percent at the end of 2008. There were also more than 2,800 foreclosures in my State, not that many compared to other States but nearly a 900 percent increase from the previous year.

This financial crisis has harmed virtually every American family. Taxpayers have financed bailout after bailout of huge financial institutions at the cost of trillions of dollars. These drastic and expensive rescues might not have occurred had there been a regulator evaluating risk to the financial system as a whole. Such a regulator could have recognized the house of cards being constructed in our financial markets.

While there are certainly many regulators at both the Federal and State levels, not one of them had the ability to evaluate risk across the entire financial system. For example, the Federal Reserve could clearly see the large number of securitized mortgages of banks within its jurisdiction, but it had virtually no visibility into the full extent of securitization at non-federally regulated banks or financial institutions under the purview of the Securities and Exchange Commission (SEC).

What was needed then and is needed now is the systemic risk regulator. The Government Accountability Office (GAO) and other government and industry officials as well as academic experts have called for the creation of such a monitor.

But, as the Chairman indicated, the creation of a systemic risk monitor raises many new questions about its structure and authority. Should it be an existing regulator such as the Federal Reserve that is charged with monitoring systemic risk or should an entirely new entity be tasked with that responsibility?

My belief is that we should establish a council composed of the heads of our Nation's financial regulatory agencies that could be an interagency task force.

We must also consider what should occur when systemic risk is detected. Should a systemic risk entity be empowered to issue its own regulations to review and approve new financial instruments

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and to fill the regulatory black holes that result from overlapping or narrow agency jurisdictions or should the monitor be required to work through existing regulators?

In designing a better regulatory framework, we must take care not to create a moral hazard by implying that this entity exists to make failure impossible. We must also take care not to stifle the creation of innovative, useful new products nor to prevent beneficial risk-sharing. The challenge is to ease the turmoil caused by failing of important institutions without setting off a cascade of trouble for otherwise healthy entities.

In other words, we need a better system to prevent the development of catastrophic concentrations of risk at firms like Bear Stearns, AIG, and better systems to mitigate the collateral damage if they do fail.

Our goals must combine several vital objectives: Stability for the financial system, safety and soundness regulation for institutions, protections for investors and consumers, transparency and accountability for transactions, and increased financial literacy for the public. Significant regulatory reforms are required to restore public confidence and to ensure that a lack of regulation does not allow such a crisis to occur in the future.

In fact, I would contend that one reason why we have not seen a stabilization of our markets is because the public continues to lack confidence. One step that we can take that would make a real difference is the creation of a stronger, more effective regulatory system to help restore that confidence, and that is why this set of hearings that the Chairman has initiated are so important.

Thank you, Mr. Chairman. I look forward to hearing our witnesses.

Chairman LIEBERMAN. Thanks very much, Senator Collins. I agree with you totally on that last point.

I know people within the Administration and our colleagues on the Banking Committee are working on this. It is very important because, obviously, the troubles in the markets, notwithstanding what we and the Administration have been trying to do, reflect a lack of confidence, and one part of that clearly is in the ability of the government to protect investors and consumers.

Let's go right to the witnesses with thanks that you are here. First is Dr. Robert Litan, Vice President for Research and Policy at the Kauffman Foundation.

Thanks for being here.

STATEMENT OF ROBERT E. LITAN, PH.D.,[1] VICE PRESIDENT FOR RESEARCH AND POLICY, EWING MARION KAUFFMAN FOUNDATION

Mr. LITAN. Thank you very much, Mr. Chairman and Senator Collins for inviting me to appear on this very distinguished panel.

We are here, of course, because we are all in the midst of the worst financial crisis of our lives and because of our ardent desire to never see something like this again. To realize this objective, we must reduce and contain systemic financial risk, the subject of this hearing.

[1] The prepared statement of Mr. Litan appears in the Appendix on page 158.

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Your staff has asked me to provide a few scene-setting remarks before addressing the questions you posed.

Our financial system has long rested on two pillars: Market discipline and sound regulation and supervision of key financial institutions and markets. Both pillars failed us.

Shareholders and creditors of now failed financial institutions did not prevent what happened, but also we did not have policies in place to assure that market discipline would work effectively.

Mortgage documents and the securities backed by mortgages were not transparent. With too many borrowers, the institutions that securitized their loans and the institutions that bought these securities also did not have enough money at risk to ensure prudent behavior.

Likewise, we all thought that regulators were on top of the risk and the capital levels at our financial institutions. We were wrong.

Reforms are needed to fix these errors. We are here today, however, to do more than that, specifically, how to address systemic risk which, as you, Mr. Chairman, accurately described, is the transmission of losses at one or more failed financial institutions simultaneously or at near time coincidence with each other throughout the rest of the financial system.

I also agree with you that we cannot expect to prevent all future asset bubbles like the housing bubble, but the public does have a right to expect reform to reduce the size of those future bubbles and, obviously, to reduce the economic costs when they pop.

The place to begin is to establish an effective system of regulating the solvency and improving the transparency of systemically important financial institutions (SIFIs).

In my view, this oversight is best carried out by a single agency, not a collection of agencies, with due apologies to Senator Collins. President Truman had a famous sign on his desk: The buck stops here.

Well, the buck stops here dictum, if we apply it here, and I think we should, means that one agency, not many agencies, should have clear responsibility over SIFIs. Among the alternatives that I survey in my written remarks, I believe that the ideal solution, if I could play God, is to consolidate all the Federal financial regulation into two bodies, one for solvency and the Treasury under former Secretary Henry Paulson.

Chairman LIEBERMAN. Just go into that a little bit. When you say all, just give us a little more detail of what agencies we are talking about.

Mr. LITAN. On the banking side, I am talking about all the banking agencies. I think we ought to have Federal regulation of large systemically important insurers which we, of course, now do not have at all.

Chairman LIEBERMAN. So when you are saying all the banking regulators, you are talking about the Office of the Comptroller of the Currency (OCC).

Mr. LITAN. OCC and the Federal Deposit Insurance Corporation (FDIC).

Chairman LIEBERMAN. Right.

Mr. LITAN. And the Federal Reserve functions of solvency. And you have large insurers. I would put them there too.

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You would have the solvency of broker dealers. Essentially, an agency charged with solvency. Then you would have an agency charged with consumer protection which would consolidate all the consumer protection arms of each of these agencies. Plus, I would add the consumer protection power of the of the Federal Trade Commission (FTC), and we ought to have a financial consumer protection agency.

I mean those are the two functions that we are worried about, and in an ideal world I would consolidate them.

Chairman LIEBERMAN. Then the SEC and the Commodity Futures Trading Commission (CFTC)?

Mr. LITAN. I would combine those and make them part of the consumer protection agency.

Chairman LIEBERMAN. OK.

Mr. LITAN. And the Paulson Treasury plan had—I am departing now from my prepared remarks here. But they also suggested that the Federal Reserve would be a free safety, roaming out there to pick and choose what it wanted to do.

In my written remarks, I am worried about the free safety model because it is just a recipe for regulatory overlap, especially with vague and ambiguous powers that you would give the Federal Reserve.

So, to go back to what I was saying, that is my ideal world.

We do not live in an ideal world, and I do not expect something like this to happen. I would be glad if it did. So, as a fallback, I urge that the Federal Reserve be the logical systemic risk regulator.

My third choice would be to create a new regulator and leave everything else intact. I am not wild about this alternative because we already have enough cooks in the kitchen. This would just add another one, and it would be a recipe, I think, for overlap, jurisdictional fights, and fingerpointing after the fact and so forth.

And, finally, we come to the last suggestion which is the so-called college of supervisors. I am not wild about this either because it preserves too many cooks in the kitchen. I think, again, as I said, it violates the buck stops here principle. So that is my least favorite alternative.

Now there are a lot of details of how systemic risk regulation would have to be carried out, and so I think the Congress, if I were writing legislation, should provide very broad language and leave the details to the agency and then have Congress oversee the agency rather closely.

Let me just give you an example of a few of the issues that would have to be addressed:

First, there has to be a clear process for identifying the SIFIs and to allow an institution that is designated as a SIFI to remove itself if the situation warrants.

Factors such as size, leverage and the degree of interconnection with the financial system, as the Group of Thirty has suggested, would be, I think, obvious ways to define the SIFIs. Clearly, large banks, large insurers and, conceivably, some hedge funds and some private equity funds could meet the SIFI test. So would the major clearinghouses, the exchanges, including the new exchanges or clearinghouses that are now contemplated for credit default swaps.

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Footnote: There is a recent report by the Geneva Reports on the World Economy—an excellent report, by the way—that has come out. It also recommends something like this, but it suggests in an ideal world that the list of SIFIs would be kept private. You would not publicize the names of them to address the moral hazard concern that, Senator Collins, you rightly point to.

I do not think that is feasible because the reality is you would have to disclose, if you were a public company, what special rules you are subject to, if you have higher capital and liquidity rules. And the markets would be able to interpret very clearly, if you have these higher standards, that you are a SIFI. So I think you cannot keep the list quiet. That is just my view.

Second, SIFIs should be subject to tougher regulation, specifically capital and liquidity, than other financial institutions precisely in order to address the moral hazard concern. Capital standards should be countercyclical but only if the minimum capital standard is raised over time and—and this is very important—the required ratios for good times and bad are publicized in advance so that everybody knows what the rules are. If you do not have clear rules what will happen is that you will relax the rules in bad times, but you will not raise them in good times. So the capital rules have to be super clear at the outset.

Third, the systemic risk regulator should not rely solely on supervisors to watch over SIFIs because we know that supervisors and regulators are not perfect. Trust me. I have been hearing an earful from the public about this.

So I think we need to harness what I call stable market discipline to supplement regulators, and the best source of stable discipline is long-term uninsured, unsecured, and subordinated debt. SIFIs should be required to back a certain portion of their assets with this long-term debt, or the long-term money which cannot run. Such debt is not like short-term deposits. Because the long-term money is stuck, the holders of such debt have tremendous incentives to monitor the institution to insure that it is not taking excessive risk, and that is another way to address the moral hazard concern.

Fourth, and this is critically important, SIFIs should be required to submit and gain approval for early closure and loss-sharing plans in the event they get into trouble. These plans could limit, though possibly not eliminate, losses from their failure. I was going to address some of the critics of the SIFI approach, but I think we have addressed the moral hazard concern, and I will not go into great detail on that issue. I have a number of responses to the other criticisms in my written testimony.

I have a couple final points. One is that you cannot put all your eggs in a systemic regulator basket. There have to be other tools to address systemic risk, and so I address two of them in my testimony.

First, my colleague, Alice Rivlin at Brookings, has suggested that the systemic risk regulator provide an annual or perhaps more frequent report to Congress on systemic risk regulation. Highlight the areas, for example, of rapid asset growth or areas where there may be particular vulnerabilities so that the system, you and the public

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are alert to the dangers. And, if there are needed recommendations, the regulator would provide them.

Second, regulators should encourage financial institutions to tie their pay to long-term performance, not to short-term results.

Finally, I want to say just a few words about the global nature of the problems we are facing and what we should do about them globally.

Clearly, we are all witnessing the fact that the troubles in the United States have now reverberated around the world. So, naturally, the rest of the world wants us to participate in some kind of global macro solution to the current problems. That is why President Obama is going to the April 2, 2009, meeting in London. That is why President Bush agreed to the G–20 meeting in November.

I have a couple words of caution, not that I am against global coordination. I am all for that. We need to learn from other countries. But for those who say that we ought to harmonize all our rules with the rest of the world before we act, I strongly disagree, and I will give you a prime example why.

We have something called the Basel II Capital Accords. I have written for years about how I think these things were horribly mistaken. As it turns out, the biggest mistake is they took 10 years to develop, and by the time they went into effect we had a full blown banking crisis. And so, I hate to repeat that episode.

By the way, the substance of the Basel rules turned out to be bad. They ignored liquidity. They were 400 pages of complexity that only risk modelers could love. They delegated authority to credit rating agencies, and now we learned how that was a mistake. There were complicated formulas that tried to measure risk that did not do it well.

The bottom line is let's not spend our time trying to negotiate with the rest of the world what our rules should be. We know enough to fix our own problems, and we should do that.

And the final point I would like to make goes to the issue of a global financial regulator. I do not think any of the countries in the G–20 are ready to cede financial regulation to an uncreated, untested global regulator. We have plenty of work to do at home, and I think we should do it.

That will conclude my formal remarks. Thank you.

Chairman LIEBERMAN. Thanks very much, Dr. Litan. Very helpful. Very interesting.

I gather that at 11 a.m., according to the previews, Prime Minister Brown may be talking about an international global financial New Deal. Though I must say I heard him respond to a question about that on the radio yesterday, and his answer was quite vague which meant either that he was holding the details for this morning or there are no details, and we will see as time goes on.

Senator COLLINS. Mr. Chairman, I just want to explain to our witnesses that I have a conflict that I need to leave for. I have read all of their testimony, and I am very interested. If humanly possible, I will try to get back, but I do look forward to talking further with the experts that you have brought together today.

Chairman LIEBERMAN. Thanks very much, Senator Collins, and I understand why you have to go. And thank you for being in this,

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as in most everything else, such a supportive partner. Thank you very much.

Next, we are going to hear from Damon Silvers who is Associate Counsel at the AFL–CIO and a member of the Troubled Asset Relief Program (TARP) Congressional Oversight Panel.

We probably could hold a separate hearing on that, but for now we welcome you on the question before us this morning, Mr. Silvers.

STATEMENT OF DAMON A. SILVERS,[1] DEPUTY CHAIR, CONGRESSIONAL OVERSIGHT PANEL, AND ASSOCIATE GENERAL COUNSEL, AFL–CIO

Mr. SILVERS. Thank you, Mr. Chairman, and thank you for the honor of inviting me here today.

As you know, I am Associate General Counsel of the AFL–CIO, and I am a member and Deputy Chair of the Congressional Oversight Panel.

My testimony today will include a discussion of the Congressional Oversight Panel's report on regulatory reform mandated by the Emergency Economic Stabilization Act of 2008.[2] However, my testimony reflects my views and does not necessarily reflect the views of the panel, its chair, Elizabeth Warren, or its staff.

We have inherited a financial regulatory landscape designed in part to address issues of systemic risk. The SEC's disclosure-based system of securities regulation and the FDIC's system of deposit insurance came into being not just to protect the economic interests of depositors or investors but as mechanisms for insuring systemic stability, respectively, by walling off bank depositors from broader market risks and ensuring that investors in securities markets had the information necessary to police firm risk-taking and to monitor the risks embedded in particular financial products.

But, as both the Chairman and Senator Collins have noted, in recent years, financial activity has moved away from regulated and transparent markets and institutions and into the so-called shadow markets. Regulatory barriers like the Glass-Steagall Act that once walled off less risky from more risky parts of the financial system have been weakened or dismantled. And we have seen a significant concentration in banking activity in the hands of very large financial institutions.

So we entered the recent period of extreme financial instability with an approach to systemic risk that looked a lot like that applied during the period following the creation of the Federal Reserve Board but before the New Deal.

But with the collapse of Lehman Brothers and the Federal rescues of AIG and Fannie Mae and Freddie Mac, the Federal response turned toward a much more aggressive set of interventions in an effort to ensure that after the collapse of Lehman Brothers there would be no more defaults by large financial institutions. Of course, this kind of approach was made much more explicit by the Emergency Economic Stabilization Act and the TARP program.

[1] The prepared statement of Mr. Silvers appears in the Appendix on page 178.
[2] The report submitted by Mr. Silvers appears in the Appendix on page 190.

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It has become very clear that our government and other governments around the world will step in when major financial institutions face bankruptcy. We do not live in a world of free market discipline when it comes to large financial institutions, and it seems unlikely that we ever will. But we have no clear governmental entity charged with making the decision over which company to rescue and which to let fail, no clear criteria for how to make such decisions, and no clear set of tools to use in stabilizing those that must be stabilized.

And I would submit to you that, unfortunately, the Act passed last fall did not really fix these problems.

In addition, we appear to be hopelessly confused as to what it means to stabilize a troubled financial institution to avoid systemic harm. In crafting a systematic approach to systemically significant institutions, we should begin with the understanding that while a given financial institution may be systemically significant, not every layer of its capital structure should necessarily be propped up with taxpayer funds.

In response to these circumstances, the Congressional Oversight Panel, in its report to Congress mandated by the Emergency Economic Stabilization Act, made the following points about addressing systemic risk:

First, we agreed with both you and Senator Collins and the prior witness that there should be a body charged with monitoring sources of systemic risk in the financial system, and we left open the options that it could be a new agency, an existing agency, or a group of existing agencies.

Second, the body charged with systemic risk management needs to be fully accountable and transparent to the public in a manner that exceeds the general accountability mechanisms present today either in the Federal Reserve Board or in other self-regulatory organizations. If the Congress and the President were to look to the Federal Reserve, the panel recommended that there would have to be governance changes.

Third, contrary to Mr. Litan's testimony, we should not identify specific institutions in advance as too big to fail, but, rather, we should have a regulatory framework in which, in a graduated fashion, institutions have higher capital requirements and pay more in insurance funds on a percentage basis than smaller institutions which are less likely to need to be rescued as being too systemic to fail.

Fourth, we do, here, very much agree with Mr. Litan that systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets.

Fifth, effective protection against systemic risk requires that shadow markets—institutions like hedge funds and products like credit derivatives—must not only be subject to systemic risk-oriented oversight but must also be brought within a framework of routine capital market regulation by agencies like the Securities and Exchange Commission.

Sixth, and here again I echo the testimony of the prior witness, we found that there are some specific problems in the regulation of financial markets—such as issues of incentives built into execu-

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tive compensation plans and the conflicts of interest inherent in the credit rating agencies' business model of issuer pays—that need to be addressed to have a larger market environment where systemic risk is well managed.

And, finally, the panel found that there will not be effective reregulation of the financial markets in general, and including in the area of systemic risk, without a global regulatory floor. However, I think it is very clear that our recommendations agree with Mr. Litan that this should not and cannot be an excuse for inaction here in the United States now.

As to who exactly should be the systemic risk monitor, well, the panel made no recommendation.

I have come to believe that the best approach is a body made up of the key regulators much as Senator Collins described. There are several reasons for my conclusion.

First, such a body must have as much access as possible to regulatory agency expertise and to all the information extant about the condition of the financial markets, including not just banks and bank holding companies but securities, commodities, and futures and consumer credit markets, more broadly.

The reality of the interagency environment is that for information to flow freely all the agencies involved need some level of involvement with the agency seeking the information, and I do not believe it is practical or wise to try to duplicate or centralize all capital markets information in one new agency or one existing agency.

Second, as I noted earlier, the panel concluded this coordinating body must be fully public.

While many have argued the need for this body to be fully public in the hope that would make for a more effective regulatory culture, the TARP experience which you alluded to, Mr. Chairman, highlights a much more bright-line problem. An effective systemic risk regulator must have the power to bail out institutions. The experience of the last year is that liquidity provision is simply not enough in a real crisis.

An organization that has the power to expend public funds to rescue private institutions must be a public organization. Here, the distinction really is between lending money and investing in equity much as we have done in the TARP program, though such a body should be insulated from politics—much as our other financial regulatory bodies are—to some degree by independent agency structures.

As to the Federal Reserve, while the Federal Reserve can offer liquidity, many actual bailouts, as I said, require equity infusions which the Federal Reserve currently cannot make nor should it be able to make as long as the Federal Reserve continues to exist as a not entirely public institution. In particular, the very bank holding companies the Federal Reserve regulates today are involved in the governance of the regional Federal Reserve banks that are responsible for carrying out the Federal Reserve's regulatory mission on a daily basis and would, if the current structure were untouched, be involved in deciding which member banks or bank holding companies would receive taxpayer funds in a crisis.

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These considerations also point out the tensions that exist between the Board of Governors as to the Federal Reserve's role as central banker and the great importance of distance from the political process in that function and the necessity of political accountability and oversight once a body is discharged with disbursing the public's money to private companies that are in trouble. That function must be executed publicly and with clear oversight or else there will be inevitable suspicions of favoritism that will be harmful to the political underpinnings of any stabilization effort, and I think we have seen some of that in recent months.

One benefit of a more collective approach to systemic risk monitoring, as Senator Collins suggested, is that the Federal Reserve Board could participate in such a body, and I believe that is essential. You cannot do this function, I think, without the Federal Reserve's involvement while having to do much less restructuring of the Federal Reserve's governance that would likely be problematic in terms of the Federal Reserve's monetary policy role.

More broadly, these issues return us to the question of whether the dismantling of the approach to systemic risk embodied in the Glass-Steagall Act was a mistake.

We would appear now to be in a position where we cannot wall off more risky activities from less risky liabilities like demand deposits or commercial paper that we wish to insure. On the other hand, it seems mistaken to try and make large securities firms behave as if they were commercial banks.

Finally, as I said earlier, the regulation of the shadow markets and of the capital markets as a whole cannot be shoved into the category labeled systemic risk regulation and then have that category effectively become a kind of night watchman effort.

The lesson of the failure of the Federal Reserve to use its consumer protection powers to address the rampant abuses in the mortgage industry earlier in this decade is just one of several examples going to the point that without effective routine regulation of financial markets, efforts to minimize the risk of further systemic breakdowns are not likely to succeed.

In conclusion, the Congressional Oversight Panel's report lays out some basic principles that, as a panel member, I hope will be of use to this Committee and to Congress in thinking through the challenges involved in rebuilding a more comprehensive approach to systemic risk.

The key, though, in the end is to make sure that as Congress approaches the issue of systemic risk, it does so in a way that bolsters a broader re-regulation of our financial markets, closing in a day-to-day way the profound gaps in our system that both you and Senator Collins alluded to, and that systemic risk regulation, while it is important that it be done, does not become an excuse for not engaging in that broader re-regulation.

Thank you very much.

Chairman LIEBERMAN. Thanks, Mr. Silvers. Excellent statement. I will have some questions for you.

Our last witness is Bob Pozen. It is good to see you again.

Mr. POZEN. Glad to see you, Senator.

Chairman LIEBERMAN. We go back some distance to our halcyon student days.

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Mr. POZEN. Yes, those were the days.

Chairman LIEBERMAN. Those were the days, my friend. That is the end of our discussion of that subject.

But, Mr. Pozen has gone on to be a leader in the financial services business over the years. He comes to us today from MFS Investment Management and has really been a creative thinker on a lot of public finance questions over the years, to the benefit of Congress and previous presidents.

So, it is great to have you here today to help us understand this question and hopefully to do something constructive about it. Thank you.

STATEMENT OF ROBERT C. POZEN,[1] CHAIRMAN, MFS INVESTMENT MANAGEMENT

Mr. POZEN. Thank you, Senator, and thank you and your Committee for inviting me to speak.

Instead of giving a long presentation, let me try to really focus in on a few of the issues.

Are we likely to have more or less systemic risk failures?

There was a study done on how many financial crises we have had in the 20th Century. This study was done by Professor Eichengreen from Berkeley. From 1945 to 1971, there were 38 financial crises across the world. Between 1973 and 1997, there were 139 financial crises of which 44 took place in high income countries. In the last decade, besides this one, we have seen the Asian financial crisis and the dot.com crisis.

So I think it is fair to say that the trend line for crises is definitely rising.

Now you ask a good question about what is systemic risk, and I do agree that it is a term that is loosely thrown around a lot. To me, one of the more useful exercises is to think about what historically have been the leading indicators that have come before financial crises if you look at them as a group. There are five indicators that we can say that tend to occur, though not always, before a financial crisis.

The first is that when a country has a very much above trend line set of real estate prices. This is not just true in the United States but was true in Japan, and also was true in Australia and other countries.

A country must be way above trend line, which is what we were, and financed by a credit boom. You need both—not just real estate prices above trend line, but also financed by a credit boom of easy money. That combination is often associated with a crash at the end.

The second leading indicator is very high leverage ratios. For example, if we look at all the things that happened in 2004, the SEC agreed to essentially allow the five investment banks to triple their leverage ratios from about 10 to 1 to 30 to 1.

Such a high leverage does lead to a potential for systemic risk because then all you need is a small loss, and you are in trouble. At that point, you would like to raise capital, but you cannot. And

[1] The prepared statement of Mr. Pozen appears in the Appendix on page 304.

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so, you start selling assets, which depresses the price of assets held by others. In this manner, you start a downward spiral.

The third leading indicator is when you have gaps in the regulatory system. Here, probably the most obvious was for credit default swaps (CDS). But these gaps for CDS were not hidden. People knew them. People saw them. People had a chance to make a decision on them, and they chose not to act. Then in this regulatory vacuum, credit default swaps increased quickly to the $50 to $60 trillion level of nominal value.

The fourth leading indicator is having an asset class that experiences explosive growth. That is what we saw in the collateralized debt obligation (CDO) market, for instance. When you see a product that goes from small to very large, you ought to beware. Similarly, we went from $250 billion in hedge funds assets to $2 trillion in about 10 years. Either hedge fund managers are absolute geniuses or there is something that does not quite make sense there. So this type of growth spurt is very much worth looking at.

The fifth leading indicator is the mismatch between long-term assets and liabilities. This, obviously, was characteristic of the savings and loan crisis where you had long-term mortgages and short-term deposits.

What is less known is that many issuers of securitized assets recreated this mismatch problem. So you would have long-term mortgages bought by a special purpose entity, which would be financed by 60-day or 180-day commercial paper. Such a mismatch has the potential to create a liquidity crisis.

So those are five areas that we really ought to look at closely. It may be more useful, rather than talk theoretically about systemic risk, to focus on those five types of situations.

What should we do to prevent systemic risks from materializing? Let's start with efforts to close the regulatory gaps. We had a chance to regulate hedge funds as well as credit default swaps. But we chose not to in both cases—one a product, the other an institution.

So there were regulatory gaps which were discussed but not closed, not for lack of knowledge, but for lack of political will.

Second, we gave various regulators only partial jurisdiction over their own turf. The most important example is that the SEC did not have jurisdiction over the holding company of investment banks. In fact, if you look at the whole Lehman complex—let's say there were 200 subsidiaries—the SEC probably had jurisdiction over less than 10.

So you need a consolidated regulator for each institution because we know people can play games with affiliates and parents and these sorts of things. That is really a crucial objective.

Third, as Mr. Litan mentioned, we should not try to have all institutional monitoring done by Federal officials. We need help from the market, and the best helpers in the market are the debt holders. Unfortunately, we have now undertaken a program where the FDIC is guaranteeing 100 percent of almost all debt for 10 years—not only of banks and thrifts, but also of their holding companies. Please note that thrift holding companies include General Motors and General Electric.

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By these broad guarantees, we have created a moral hazard. We have eliminated the people in the market who are most likely to help us police these institutions—the large debt holders of these institutions.

Last, I think we do want to make sure that we are looking at institutions across the board and not just ones that have Federal charters. One category of institution with potential systemic risk is very large insurance companies which are regulated by the States. We also have the very large mortgage lenders, which under last summer's act are licensed by the States. Those are two areas where we should think about whether a few very large institutions might come under a Federal regulator.

My last point is that we should not try to form a new Bretton Woods, whatever that means. We have a hard enough time, as you know, getting everyone in the Senate to agree on legislation. Since the chance of getting all major countries to agree on a new international institution is remote, we should not spend a long time waiting for this to happen.

What should we do here in the United States?

I am personally quite skeptical about the consolidation of all financial agencies into one. We did not see a lot of benefit from the Financial Services Authority (FSA) in the United Kingdom, a consolidated regulator, in terms of preventing a financial crisis. These consolidations of agencies have as many problems as they do benefits.

As Mr. Litan pointed out, you do not want too many cooks. You want one person or agency with responsibility for each financial service. Also, you want an agency that is pretty nimble. If it is a big bureaucracy with lots of different divisions, it is hard to move quickly.

I tend to think that the Federal Reserve is the right agency to be the monitor of systemic risks. It has a lot of experience in keeping tabs on macroeconomic trends.

I also agree with Mr. Litan's point that the Federal Reserve has been acting as a consumer protection agency in the mortgage disclosure area. It is not a function that fits in very well with what the Federal Reserve does. Quite frankly, the Federal Reserve did not do a very good job in that area, so I would tend to move that function to another agency.

According to Federal Reserve officials, their jurisdiction over banks and bank holding companies helps them understand risk and other financial issues. So I would leave that jurisdiction with the Federal Reserve.

My model, which I outline in my written testimony, is that the Federal Reserve would be the central risk regulator. The buck stops there. But it would not be the primary regulator of all large financial institutions. We would leave that to the functional regulators for several reasons.

First, I do not want to identify these systemically risky institutions because then everybody will want to become one. This could pose an antitrust problem. Institutions will want to merge so that they can become too big to fail. If you are systemically monitored and you are labelled that way, then everyone will feel you will never be allowed to fail and act accordingly.

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Second, I think the functional regulators know a lot more about their areas than the Federal Reserve does. For instance, in my view, large hedge funds should be registered with the SEC, which should inspect their books and have them file reports. But the SEC should funnel information to the Federal Reserve that relates to macro risks.

And so I see us as having a lot of functional regulators feeding information to the Federal Reserve, and the Federal Reserve with the job of putting it all together. I would not start a new agency just to monitor systemic risk. To start a new bureaucracy takes a lot of time and effort.

I think the Federal Reserve, if it lost its mortgage disclosure function, is the appropriate agency to monitor systemic risks. It would have to develop more expertise in capital markets, but it would be sent information by all the functional agencies with their experts.

Then, if the Federal Reserve decided action needed to be taken to reduce the potential for a systemic failure, it would not just act itself. It would go back and consult with the primary regulator, the SEC, the insurance regulator, or the FDIC, so we would get a combined effort. You really would not want the Federal Reserve acting alone on systemic risk without the knowledge or expertise of the relevant functional agency.

So that is my recommended approach. I guess my approach is roughly between those of the prior two speakers. It is making the buck stop with the Federal Reserve, but setting up a system by which it relies on inputs from all the functional regulators. This approach would produce some of the benefits of coordination that Mr. Silbers was advocating.

Chairman LIEBERMAN. Thanks. It is very interesting, and very helpful. We will have 7-minute rounds of questions.

I find your term, central risk regulator, to be more comfortable than the systemic risk regulator. You have said, Mr. Pozen, in your ideal vision of what should happen here, the Federal Reserve would be the central risk regulator, and Mr. Silvers and Dr. Litan have also spoken about the value of a central risk regulator whether it is a new agency or a college of regulators.

I want to understand what this central risk regulator does in your vision of the Federal Reserve playing that role. To go back to my earlier observation, it is different, is it not, from filling the gaps that exist in current regulation?

Mr. POZEN. Absolutely.

Chairman LIEBERMAN. In other words, if credit default swaps in the trillions of dollars or hedge funds in the trillions of dollars are operating essentially unregulated, the systemic regulator or central risk regulator may keep an eye on that, but we need to give somebody else the authority to regulate them.

Mr. POZEN. I agree with that. Under my approach, there would always be someone else as the primary regulator except for Federal Reserve banks and bank holding companies.

Chairman LIEBERMAN. What would the Federal Reserve, as a central risk regulator, do?

Mr. POZEN. I think the Federal Reserve would focus on the five historic indicators of financial crises outlined in my testimony.

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Chairman LIEBERMAN. So they would watch out for those.

Mr. POZEN. Yes, they would look to see which products or which institutions were growing very rapidly.

Chairman LIEBERMAN. Right.

Mr. POZEN. They would look to see what financial firms had very high leverage ratios. They would look to see whether any sort of financing bubbles are being created. And I am sure if they look carefully at the history of financial crises, they would wind up with 10 more concrete indicators of what factors are likely to cause a financial crisis. Those are the areas where they ought to focus.

Further, it seems to me, it would be part of the Federal Reserve's job to point out where gaps exist and to request that gaps be filled in the regulatory structure.

Chairman LIEBERMAN. OK.

Mr. POZEN. They would not be the ones to fill them, but they would say: OK, we have this new product. It is a credit default swap. The New York State Insurance Department has declared it is not an insurance contract, but it is growing very quickly.

It is very important. It really should not be regulated by the States. It should be regulated by some Federal agency. We call on Congress to fill this gap.

Chairman LIEBERMAN. Yes.

Mr. POZEN. And that would be a second important function.

Chairman LIEBERMAN. So, right now, the Federal Reserve is not carrying out that kind of central risk regulation oversight function, not asking the kinds of questions that you and the others think should be asked as what might be called early warnings of coming broad-scale failure.

Mr. POZEN. Yes. I think, unfortunately, the Federal Reserve tends to get involved when the failure is upon us.

Mr. SILVERS. When the horse is out of the barn.

Chairman LIEBERMAN. Right. Does it have the authority now in statute to perform that central risk regulation?

Mr. POZEN. I do not think it really does.

Chairman LIEBERMAN. So that would be something we would need to do.

Mr. POZEN. It has broad authority relative to bank holding companies.

Chairman LIEBERMAN. Right.

Mr. POZEN. But it really does not have authority as a general risk monitor. It can cooperate with the other agencies, but they are not under an obligation to give the Federal Reserve information on a regular basis.

Chairman LIEBERMAN. Of course, if the Federal Reserve is not performing that central risk regulating role, no other institution is either.

Mr. POZEN. That is true, and I think that the Federal Reserve probably would need to broaden its capabilities. There are certain areas where the Federal Reserve is very strong, say, in macroeconomic analysis. Becoming a general monitor of systemic risks would require that the Federal Reserve become more sophisticated in capital markets.

Chairman LIEBERMAN. Right.

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Mr. POZEN. As I say, while the Federal Reserve has acted in part as a consumer protection agency, this seems out of sync with its core functions.

Chairman LIEBERMAN. I agree.

Mr. POZEN. So we ought to think carefully. There may be other functions that should be taken out of the Federal Reserve's mandate.

Chairman LIEBERMAN. Taken away, yes.

Mr. POZEN. And so, the Federal Reserve ought to be a bank regulator and a central risk monitor.

Chairman LIEBERMAN. Yes. In a way, you are answering the concern that some like former Treasury Secretary Paul Volcker have expressed, that if we put this function—central risk regulator, early warning, etc.—on the Federal Reserve, we may be overloading it. But you are saying, take some of what it is doing now away from it because it is less urgent.

Mr. POZEN. I think it is not only less urgent, it is a consumer protection function. As I am sure Mr. Silvers would agree, consumer protection should be the main focus of an agency.

If you tell an agency, you have to be a prudential regulator and you have to also look after consumer protection, consumer protection tends to get subordinated and solvency takes precedence.

Whether it is the SEC, the FTC, or some other agency, investor protection and consumer protection need to be placed with an agency where that is their main mandate.

Chairman LIEBERMAN. Mr. Silvers and Dr. Litan, is there general agreement on what the systemic or central risk regulator should be doing?

I know there is disagreement on who should do it among you. But do you agree that it is to ask the kinds of early warning questions that Mr. Pozen has described?

Mr. SILVERS. Mr. Chairman, I would sort of unpack that a little bit more, I would guess.

Chairman LIEBERMAN. Go ahead.

Mr. SILVERS. Well, two points. One is that I think our history of our existing regulatory bodies, including the Federal Reserve and particularly the Federal Reserve, at performing that early warning function has not been very good.

In our report, we recommend essentially a body of nongovernmental experts, academics, people like my colleagues on this panel not embedded in the daily to and fro, who would play that kind of reconnaissance function. That recommendation from the Congressional Oversight Panel, I think is in large part based on the actual track record of the Federal Reserve and, to a lesser degree, the other agencies.

Chairman LIEBERMAN. That is very interesting. And that is different from the college of regulators?

Mr. SILVERS. Yes. That is a different panel. It is not something with significant staff. Its sole purpose is to have a check outside the regulatory processes and the political processes, intellectually.

Mr. POZEN. I think it is an interesting idea. It is like an advisory commission to the Pentagon, as we now have in defense.

Mr. SILVERS. Well, precisely.

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Mr. POZEN. I think it is very consistent with having the Federal Reserve as the central risk monitor. This would be a group that would act as an idea generator and would keep the Federal Reserve on its toes. It seems like a good proposal.

Mr. SILVERS. In particular, it would issue a mandated report, in our view, to Congress on what is coming over the horizon.

Second, Mr. Chairman, this, I am afraid, is influenced by my experience and our experience with respect to TARP, that we looked at the systemic risk regulator as, in part, having this advance warning function but also necessarily being the body that acts when a systemic crisis occurs.

And it turns out, of course, we have experienced it when a systemic crisis does occur, that the range of action often turns out to be much more extensive and much more involving public money than we might have thought in advance.

Chairman LIEBERMAN. Right. I am over my time. But, Dr. Litan, why don't you get into this a moment?

Mr. LITAN. Yes. So, I have a couple of points.

One, the idea of an outside body doing the warning is an interesting idea. It is not mutually exclusive. You can have them and the Federal Reserve do this. So I think that is point one.

Point two, in an ideal world, you would like to keep the list of the SIFIs private.

As a practical matter, however, the markets will interpret any large institution that, for example, may have larger capital requirements or different liquidity requirements as being a SIFI. It will take the markets about five seconds to figure out that the regulators are treating these institutions differently, and, as a practical matter, the secret will be out.

And the last point is the issue that Mr. Pozen has raised and, actually, Mr. Chairman, you raised. Do we agree on exactly what this regulator should do? We all agree that early warning, probably supplemented with some outside advice, but I think there is some disagreement about how much the systemic regulator needs to get into the weeds.

So, under one model, let's say Mr. Pozen's model, they delegate, but they are overseeing and they are issuing thunderbolts, if you will.

In my model, I am actually having them on the front lines and being involved in the direct supervision of the systemically important institutions. They have the expertise already from supervising large bank holding companies. They would need more staff, I admit. I think you would probably borrow them from the Comptroller and other agencies.

But the thing that worries me about the sort of delegation model is that it violates the "buck stops here" principle. I worry that the Federal Reserve Chairman will call up the OCC and say, look, you ought to watch Citigroup and certain other large institutions more carefully. And the Comptroller says, I do not agree. And then they argue.

That is what happens in the real world. Now not all the time, and it is true that the Federal Reserve Chairman does have a lot of influence. But I have been in government before, at least in the Executive Branch. People have different views about these things.

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Ultimately, at the end of the day, let's take the Federal Reserve if they are going to be the agency. If they are the ones shelling out the bucks, it seems to me they ought to have the final say on what is going on underneath with the institutions.

Mr. SILVERS. But they are not shelling out the bucks. That is the problem.

Chairman LIEBERMAN. I will give you a quick response, and we will go to Senator Tester.

Mr. POZEN. Thanks. First, that would require the Federal Reserve to have deep expertise in six or seven different areas. That is not likely.

Second, I think the buck still stops at the Federal Reserve. It just gets information from these other agencies.

And, third of all, we do have the President's working group to resolve disputes among financial agencies.

Mr. SILVERS. Senator Lieberman, just one sentence about this: The Federal Reserve is not ultimately shelling out the bucks. The taxpayer is, meaning that when we move to a real systemic crisis, as we have learned through TARP, it is the taxpayer shelling out the bucks. And that is why. That underlies my view that it needs to be a public body.

Chairman LIEBERMAN. So the question is not only where the buck stops but who is shelling out the bucks.

Mr. SILVERS. Right.

Chairman LIEBERMAN. OK.

Senator Tester, you may have heard a term being used by Dr. Litan, SIFIs. I want to assure you that you arrived at the right hearing, that we are not exploring the world of Dr. Spock. SIFIs, as I have learned this morning, are systemically important financial institutions.

With that, it is all yours.

OPENING STATEMENT OF SENATOR TESTER

Senator TESTER. That is good to know, Mr. Chairman. I appreciate that because I was thinking maybe I did not do enough reading last night.

I, first of all, apologize for not being here for the beginning of the testimony. I appreciate you being here as always, and I appreciate the Chairman for calling this hearing.

As you folks well know, how we get consumer confidence back in the system is going to be critically important and how we do it and do it right is not going to be, at least from my perspective, easy.

Let's just talk about the Federal Reserve for a second and follow up on some of the things the Chairman was talking about. If it becomes the major central systemic regulator, is there fear of too much power in one agency?

Mr. POZEN. Senator Tester, it is a good question. I would answer that in two ways:

First, we were talking—and I am not sure exactly when you came in—about taking some functions away from the Federal Reserve such as consumer protection in the area of mortgage disclosure. This is not central to the Federal Reserve's mission, and perhaps it has not done as good a job as it should have.

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Second, at least under my model, the Federal Reserve would not be the primary regulator of, say, an investment bank or an insurance company. That would still stay with the functional regulators, who would work closely with the Federal Reserve. Information relating to systemic risk would be channeled to the Federal Reserve from the SEC, the Comptroller of the Currency, etc., and the Federal Reserve would have the ability to get more information from these agencies.

By contrast, if we ask the Federal Reserve to be the primary regulator of, say, the 20 largest financial institutions, then it would have a lot of power, and it would have to develop a lot of different kinds of expertise.

In my view, you solve the problem of having the Federal Reserve becoming too powerful by following a decentralized approach. I would call it a specialized expertise model. For example, the SEC would spend most of its time on investor protection; it is not focused on systemic risks. But the SEC would pass on risk-related information to the Federal Reserve, which would aggregate it with other data in analyzing systemic risks. The SEC is an investor protection agency, and that is what it does best.

Mr. SILVERS. Senator, I think your concern is well founded, and I think that it is well founded for the following reason: If you ask the Federal Reserve to play this role, you are then asking the Federal Reserve either to take on real power, as I think Mr. Litan would like it to do, or the question becomes what real abilities is this process going to have to achieve the purpose, to actually constrain systemic risk and to act in a crisis.

If we give the Federal Reserve real power, then the concern outlined in my testimony comes to the fore, which is that the Federal Reserve is not a fully public body. In particular, the operational arm of the Federal Reserve and the arms of the Federal Reserve in the financial markets, the regional Feds, are both capitalized and governed in part by the very institutions that they regulate. The result of the Federal Reserve not being a completely public institution is that the Federal Reserve is neither fully accountable or transparent to the public.

That is not an appropriate structure in which to vest either the kind of broad regulatory powers that are being envisioned here by some of my colleagues on the panel nor is it an appropriate structure to hand over the power to disburse taxpayer funds which is a necessary component of systemic risk regulation when a crisis hits. For that reason, if one wished to vest the Federal Reserve with this type of power, you would have to change its governance pretty significantly, and it is not clear that is a good idea in relation to the Federal Reserve's actual core mission which is monetary policy.

Furthermore, I am very influenced by two issues of expertise and information sharing. My colleague, Mr. Pozen, thinks it will be easily handled, but I think it will not. I think if systemic risk management is not collective among the agencies, that information will not be shared in an appropriate way. I think that is just human nature and the nature of matters in Washington.

And, second, I think that the expertise in the broader capital markets that Mr. Pozen is convinced can be easily acquired by the

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Federal Reserve is not actually that easily acquired and, second, would be completely duplicative of expertise resident in the SEC and the CFTC today.

Mr. Pozen is correct that the SEC's culture is not a risk management culture. It is a disclosure and fiduciary duty-related culture. But that is why you want to bring these agencies together to conduct this function.

The punch line, I would say, though, is that we cannot turn over this type of responsibility, either in terms of power to regulate or in responsibility to regulate and in terms of the ability to expend the taxpayer dollars to an institution that in its ultimate functioning is self-regulatory and not completely publicly accountable. It would be irresponsible to do so.

Mr. LITAN. We do not live in a perfect world. We have all kinds of tradeoffs with these considerations.

So, to the point about their governance structure, I think if you give more power to the Federal Reserve you may have to change its structure. For example, if you told the Federal Reserve that it has regulatory responsibility, you could say that part of their activity is subject to the appropriations process and is under congressional oversight.

You can leave monetary policy the way it is, where the Federal Reserve gives the money back at the end of the day, assuming it has any these days. But, in any event, you could change the way the Federal Reserve's regulatory activities are conducted. That is point one.

Point two, you could rebalance the concentration of power—for example, by transferring the mortgage or the consumer protection part of the Federal Reserve to other agencies.

At the end of the day, and I do not want to exaggerate here, we have had the financial equivalent of a nuclear meltdown. That is what it is. This is a horrific set of circumstances. Frankly, it blows my mind. I would have never expected this 2 years ago if somebody had told me this was going to happen. And God forbid anything like this should happen again.

So, at the end of the day, if that is the image that you have in your mind, do you want a committee making the decisions about this or do you want some one agency in charge?

I would feel more comfortable if someone was in charge, so at the end of the day, after it all happened, we do not have fingerpointing again, where the Federal Reserve Chairman comes before you and says, I recommended X, Y, and Z to the CFTC and the SEC and the Comptroller, but they did not listen to me. And the Comptroller says, no, we have a difference in views. And then we have fingerpointing.

At the end of the day, you, in Congress, want somebody to be held responsible. So, if the magnitude of the problem warrants it, you concentrate the power, and then you subject it to oversight to solve the transparency problem. That is my view.

Senator TESTER. Can I keep going?

Chairman LIEBERMAN. Go right ahead.

Senator TESTER. All right.

The thought occurred to me as each of the three of you were speaking that we have a Committee here of 17 members, and the

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Banking Committee has the same kind of committee, and I wondered if you three could get together and could come up with a program that would work because it is going to be five times more difficult for us, plus with a lot less expertise.

Consumer protection versus systemic regulation, are they exclusive to one another?

For instance, good central systemic regulation, is that good for consumers? Is that good for consumer protection? Does one fit the other's needs and vice versa?

Mr. SILVERS. Senator, I think there are many ironies built into the answer to your question.

The first irony is that I think it is hard to read the record of the Federal Reserve's oversight of the mortgage markets and not conclude that the Federal Reserve felt that consumer protection was an afterthought, and it turned out that without effective consumer protection there was no effective systemic risk management. Things ran exactly the opposite to what the assumption was.

I think the lesson from this—I think Mr. Pozen talked about this a few moments ago, and I absolutely agree with him—is that there is a tension between not so much systemic risk management properly construed but what it often turns into, which is the desire to protect the safety and soundness of particular institutions. There is a tension between that and consumer protection in real life.

I think everyone who has been in this area knows that typically bank regulators are safety and soundness focused, as they should be. The safety and soundness mission is quite important.

But the result when you put those two missions together is that you get neither. You get neither effective consumer protection nor effective safety and soundness regulation. For that reason among others, the Congressional Oversight Panel recommended a separate consumer protection regulator.

Now there are several options built into the report. I would make clear my view is that consumer protection in the financial markets needs to be separated from the safety and soundness mission entirely.

Then the question is where does it go? It could be a distinct agency. It could be the Federal Trade Commission which has consumer protection responsibilities. It could be the SEC.

There is a caveat to the SEC. I am an extremely strong supporter of that institution and believe it needs to be revived and strengthened. However, its conception of its mission is heavily oriented toward disclosure and toward fiduciary duties. It is not a substantive regulator of the fairness of the markets it regulates.

Consumer financial services—mortgages, insurance, insured bank accounts, credit cards—are areas that I think pretty obviously need substantive oversight. It is not clear that the culture needed matches the SEC's culture and mission.

But the larger point that consumer protection and investor protection need agencies focused on those missions is exactly right, and I hope if we learn one lesson from this meltdown that Mr. Litan described it is that if you do not get that mission right, you are very likely to get these larger systemic missions wrong as well.

Mr. POZEN. I think the short answer is that they are related and that the breakdown of one can lead to a breakdown of the other.

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However, as a matter of regulatory strategy, I strongly agree with Mr. Silvers that we probably want to take the consumer protection functions out of the Federal Reserve, put them in an agency where that is the main focus, and then the Federal Reserve will concentrate on solvency and other aspects of systemic risk. That seems to be the way to go.

Mr. LITAN. And I agree entirely with what Mr. Silvers said. In an ideal world, or even less than an ideal world, I would consolidate the SEC with something like a FTC to melt down these cultures.

I just want to make one additional point. In my professional life, I am sort of bicoastal. I live in Kansas City, but I am also affiliated with the Brookings Institution. So I am here on the East Coast a lot. Aside from the disadvantage of traveling on airplanes, the advantage of being bicoastal is that I get to live in the Heartland and hear real people most of the week, and it has been good.

I will tell you one of the things I have heard from traveling around the country, and I am sure that you too, when you go back to your home districts, hear this. The public is not only furious, the public has no confidence in our regulatory system. When I talk to groups about how to try to fix this and reorganize the government, at the end of the day, I want to tell you that I think we have an unbelievably skeptical public about the ability of regulation to fix the financial system. So that whatever we do, wherever we lodge the power, we have a huge uphill road to climb with the public.

And what really has sent people over the edge is the Bernie Madoff affair. People all over America are asking: How could something like this happen in the United States?

And so, in addition to your point about the culture of the SEC being different from the others and how we have to change the culture there, we also have to convince a very skeptical public right now that there is a fix out there that will work.

Senator TESTER. I will just tell you I hear the same exact thing, and I, quite frankly, am just as frustrated and just as furious as they are. Whether you are talking about Mr. Madoff or whether you are talking about how some of those TARP funds were used. We will just leave it at the fact that things are not running smoothly at this point in time.

I think they will be fixed. I think it is just a matter of time and getting some common-sense regulation. But what is good for consumer protection, I heard you guys say, is also good for systemic regulation, and that is important.

I do have some other questions, but I will wait for another round. Thanks, Mr. Chairman.

Chairman LIEBERMAN. Thanks, Senator Tester.

Senator Tester is one of, I think, two Members of this Committee who is also on the Banking Committee. So that is an important overlap.

I agree with you. I hear the same thing at home. Even though the Madoff scandal is not, at its heart, relevant to or the same as the housing bubble, the credit default swaps, etc., it does connect to the critical point of whether there was a fiscal cop on the beat. How could this guy get away with this Ponzi scheme particularly

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when we now have this gentleman who seemed to have been trying to get the SEC to investigate for years?

So this work is urgent. I know that the President hopes to at least have an outline of a proposal before he goes to London in early April. But it is critical now in terms of the confidence without which the economy will not recover.

Senator Burris, thanks for being here. We turn to you now.

OPENING STATEMENT OF SENATOR BURRIS

Senator BURRIS. Thank you, Mr. Chairman.

I certainly have gone through the testimony of the witnesses even though I was not here to listen to them.

Being an old banker and a part of some of that system during my younger days, I am just wondering, where did we lose control of this situation?

You have the FDIC, the Comptroller of the Currency, the SEC, all of these regulators. Was it turf that started some of this or nobody ending up with complete oversight and authority for something like this to happen?

When we got rid of Glass-Steagall, the banks started using all types of different instruments and insurance and all these other things. Where did we lose control for the systemic problem to come in?

Mr. SILVERS. Senator, there are probably as many answers as there are hours in the day to that question, but let me give you a couple of thoughts that you may be surprised by.

One thing that is quite striking right now as we look at the crisis of our mega-institutions is how few actual bankers you find running them. When you start asking, well, who is in charge here? Where are the people who know about underwriting loans? The sort of old-fashioned bankers?

Senator BURRIS. Which I was, an old-fashioned banker.

Mr. SILVERS. They are hard to find, and that, I think, tells us something fairly deep.

I will take it one step further. We moved very dramatically over the last 30 years, and you can see it in all kinds of statistics about where financial assets are, away from banking and institutions and toward markets, toward derivatives markets, toward securitization markets and so forth.

There are a number of advantages to having done that, but it is hard not to look at what has happened and also see that there have been some profound disadvantages to that, including, and I think the Chairman referred to this in his opening remarks, the lack of skin in the game, in securitizations, for example.

There is a deep belief among many academics that markets are extraordinarily good at capturing information and making decisions about things like risk. It is a little unclear to me, looking at this landscape and this history, as to whether that is really true in relationship to the old-fashioned kind of banking activity that you were just describing.

Second, with respect to regulators and where did we lose control on a regulatory basis, I think several big bad ideas got going. One big bad idea that I refer to in my written testimony goes back into the 1970s, which is the notion that financial regulation is about

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protecting the weak, so that basically we look very heavily at how essentially poor people are treated and consumers are treated, but we do not look very much at large, sophisticated actors because we figure they can take care of themselves.

That idea, and I am not in any way at all against consumer protection or against measures for the weak, but the idea that we let the strong do whatever they want turns out to be exactly what produces a systemic catastrophe. It also fed this notion of regulatory loopholes, regulatory holes in our system.

Then, finally, I would just observe that it is very clear that the place where the breakthrough really took off, the moment in time when we really let our credit systems run loose was in the very early part of this decade. It is what I would call essentially idiot Keynesism. Policy decisions were made to stimulate our economy through individual borrowing rather than intelligent Keynesism which is what I think Congress and the President are engaged in today.

That is an unsustainable move, idiot Keynesism. You cannot stimulate an economy through lending money to people who cannot pay it back.

I would finally note, and I think this will not surprise you now, coming from an employee of the labor movement, that ultimately the decision to try to have a high consumption, low wage society was a prelude to disaster and that we tried to make up the gap through credit, and it is not a sustainable strategy.

Mr. POZEN. Let me just take up one aspect of what Mr. Silvers said because it has not been focused on that much.

Senator BURRIS. Sure.

Mr. POZEN. I personally was recruited to serve as an outside director of two large banking institutions, and I was shocked by how little expertise there was on those boards. In the end, regulators can only do so much. The day to day, month to month work must be done by boards. But if you look at a lot of bank boards, you really have to question whether they have enough financial expertise to deal with these very complex institutions.

You can argue that if somebody does not really know much about banking, then they may be very independent. But is that the type of director we want for large banks? In the end, I could not be a permanent member of those boards because I had a potential conflict of interest.

So we have a lot of very distinguished people on bank boards, who spend one day every other month for a total of 6 days a year. They are not banking experts, and these are very complex institutions. They do not seem to have known very much about the significant risks taken by these institutions.

I would suggest that there is a different model of a board of directors, which you see in companies that are owned by private equity funds. These boards have five or six directors, not 12 or 14. Almost all those directors are retired executives from the relevant industries, and they spend 3 to 4 days a month at the company.

Also, their compensation is structured differently—low base salaries with significant stock options. Those directors really care about what happens to that institution. They have the time, the expertise, and the financial incentive.

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So, in my view, we should consider a different model for corporate governance. I cannot address all types of companies, but for large and complex financial institutions, you really need a different board structure. This is one of the subjects that has not been focused on yet.

Look at the Citigroup board, filled with distinguished people. But where was the audit committee when all these risky deals and practices were happening?

The directors followed all the rules in the Sarbanes-Oxley Act. They were all independent. So there are limits to a procedural approach to governance.

But the directors of Citigroup, as opposed to a private equity board, were not experts on financial institutions. They did not spend a lot of time on company business, and they did not have sufficient financial incentives aligned with the shareholders.

We do not have to ask whether a chief executive officer (CEO) from a company controlled by private equity received a golden parachute when he or she was fired for doing a poor job. It has never happened, and it probably never will happen. If we had the right board of directors, it would not have happened at these financial institutions.

Mr. LITAN. Senator, just a few extra things because we could go on, as Mr. Silvers said, forever.

You know lawyers frequently describe what are called but-for-causes of accidents. But for X, Y, or Z, it would not have happened. In all the tomes that are going to be written about this financial crisis, there are lots of but-for-causes, and we have heard just some examples. I am going to give you my top three. All right?

If you look at the subprime numbers, they went off the charts in 2004, 2005, and 2006.

Chairman LIEBERMAN. What do you mean by subprime numbers? You mean the number of subprime mortgages?

Mr. LITAN. The number and the volume of securitizations, they went through the roof in those years.

If we could have replayed history and notwithstanding that we have State mortgage brokers—if we had minimum standards for mortgage origination that would have prevented no documentation loans, no income loans, and loans to people without any down payment, a huge amount of the subprime explosion would have never happened. That is point one.

Second, there was gasoline all over the floor of the financial system in the form of excessive leverage. That was what I think both Mr. Silvers and Mr. Pozen have talked about. So that when the mortgages blew up, they ignited the fire, and the fire was fed by the leverage.

Part of it was the SEC liberalized the rules on the securities companies and, in particular, allowed them to fund their assets with too much short-term money, which proved to be highly destabilizing. The government-sponsored enterprises (GSEs) also were way under-capitalized, and now we saw what happened to them. So the second thing is that our key financial institutions did not have enough skin in the game.

And the final point relates to credit default swaps. Part of the reason investors thought subprime securities were safe is that they

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were backed by bond insurance or you could buy a credit default swap to cover risk of default.

As it turned out, however, the bond insurers were asleep. The ratings agencies also were asleep because they all had their models based on a few years, not on any long historical period. And the credit default swap market is basically an insurance market that was unregulated, and we allowed dealers to write contracts with not enough money in the till to pay it back when the bills came due. Now we, the taxpayers, are paying all those bills.

I honestly believe even with all the other problems that Mr. Pozen and Mr. Silvers have talked about I think we would have escaped a good portion of this disaster if we had addressed these three items.

Senator BURRIS. Mr. Chairman, we have to leave shortly. So I have a lot more questions, but I will yield at this point, and hopefully we can continue this at some other time.

Chairman LIEBERMAN. Thanks, Senator.

This has been a great panel, both in your individual ideas and in the back and forth between you. Maybe we will see if we can do a final round if the three of us want to stay at 5 minutes each, and we will get out of here hopefully in time to get to Prime Minister Brown.

You have all convinced me that we do need a systemic risk regulator or a central risk regulator in some sense. Depending on your model, it may not be a regulator. It is a kind of financial system overseer in the sense of advance warning.

We are holding this hearing pursuant to the traditional Governmental Affairs jurisdiction of this Committee. In the last 5 years, we received a new jurisdiction, Homeland Security.

And I go back to, Dr. Litan, your reference to what we are experiencing now as a financial meltdown comparable to a nuclear meltdown.

There are, to me, as I listen to your testimony, stunning comparisons to the work we did after September 11, 2001, which led to the creation of the Department of Homeland Security (DHS) and, an even better example, the Director of National Intelligence (DNI). Because what were we saying after September 11, 2001?

There was nowhere where the dots could be connected. If this agency of the Federal Government had shared what it knew with this agency and that agency, I tell you in the end I concluded from all I have seen that we could have prevented September 11, 2001. But they were not.

So, in a way, it is that, but it is also putting somebody up on top, looking out over the horizon, constantly asking the question: Are we seeing something here that is really troublesome that could lead to a major economic crisis or system failure?

You have convinced me of that, but there remain important questions for all of us. Who does it? What are the kinds of authorities that group has?

But now I come to the other part of this, and let's just go to the final part of your last answer, Dr. Litan. We know that there were certain kinds of economic activity that were extremely consequential that were simply not regulated. Credit default swaps are one. Hedge funds are another.

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So I want to ask you for a quick answer. I have spoken too long now.

A central risk regulator is not enough of a reform to avoid a repeat of this mess we are in here. I presume we need to regulate some of the activity, like the credit default swaps, that brought the house down. And I want to ask you quickly if I am right and just quickly, if so, who should do this? Who should oversee credit default swaps or hedge funds or anything else you think contributed to this?

Mr. LITAN. So, shortly, I talk about credit default swaps in my testimony.

Chairman LIEBERMAN. Right.

Mr. LITAN. As much as I want the Federal Reserve to be on the front lines of the so-called SIFIs, I am not confident that they are the best regulator of credit default swaps or any derivatives market. I still see a role for the SEC or the CFTC directly overseeing that.

People are talking about clearinghouses now being formed which will reduce the risk, but you have to regulate the clearinghouse. You have to make sure it is solvent.

Chairman LIEBERMAN. Yes.

Mr. LITAN. And then you have all these customized contracts which will not be cleared. What do you do about them?

I think maybe one way to do this, and I am not necessarily advocating it, is to have the Federal Reserve overseeing all this, getting the relevant information from the agencies. But to satisfy my desire that there be some teeth, you could give the Federal Reserve the authority so that if it walked in and said, look, Citigroup is not doing the right thing or there is a section of the market that needs to be looked at or whatever, the Federal Reserve could at least do something on its own initiative and not just be stuck with calling on the phone and saying, please will you do this? That worries me.

Mr. SILVERS. Mr. Chairman.

Chairman LIEBERMAN. Yes, I was going to ask the two of you, quickly. What about derivatives markets that are unregulated, hedge funds, etc.? Is that the SEC or the CFTC that we should give that to by statute?

Mr. SILVERS. Senator, my view is that what President Obama said at Cooper Union during the campaign is the right answer, conceptually. Things should be regulated for what they are, not what they are called.

Those derivatives that are based on securities, where the underlying instrument is a security, need to be under the jurisdiction of the SEC or a merged SEC and CFTC.

Those derivatives that are effectively insurance need to be regulated like insurance. It does not mean that they need to be regulated exactly the same as an insurance policy but the same capital requirements notions and the same review as to whether they do what they say they do needs to be done.

With respect to hedge funds, it is clearly something that ought to be under the SEC. A hedge fund is nothing but a money manager, and it needs to be there. If the hedge fund is engaged in activity that substantively is insurance, for example, by selling a credit default swap, then it needs to be regulated as if it is selling

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insurance—again, not exactly like an insurance company but with those principles in mind.

And I think that is Mr. Pozen's point about somebody has to be watching the safety and soundness of whoever is doing this.

Chairman LIEBERMAN. That is helpful. Mr. Pozen, a last word?

Mr. POZEN. I agree that the SEC should regulate hedge funds, and the merged SEC and CFTC, which I agree should happen, should regulate hedge funds and credit default swaps.

I just add one more point. One of the great accomplishments of the 1975 Securities Act amendment was to merge the back offices of all the securities exchanges into the Depository Trust Company (DTC) and one clearing corporation. There was a complicated trade-off between antitrust considerations and operating efficiencies in the public interest.

We have lots of groups now who want to be the central clearing agency for credit default swaps, so many that there is a lot of infighting. In my view, it would be great to have one clearing agency for the whole world of swaps; or at least, one for the United States and one for Europe. If we have a lot more, we are losing a lot of the benefits of a clearing corporation.

We should look at the national market legislation of 1975 and see whether we can pass a similar bill creating one central clearing house for CDS. We do not really want people competing on the back office.

Chairman LIEBERMAN. Good. Thank you. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

The comments about the subprime and the no documentation and the low documentation loans are something that is interesting to me because I cannot imagine people lending money with no documentation unless you can sell it to somebody who does not know there is no documentation there, which is exactly what happened.

Are there any provisions? You will have to be concise with your answers because we just have a limited amount of time.

Are there any provisions with Gramm-Leach-Bliley that we need to revisit? And if you can be as concise as possible, it would be great.

Mr. LITAN. I do not think so and this is where I disagree with Mr. Silvers. I do not think Gramm-Leach-Bliley contributed to this, Senator Tester.

And the very simple point that we had commercial banks and investment banks that were not affiliated with each other that went over the edge by themselves. It was not the fact that they got merged together that allowed this. I think it would have happened anyhow.

Senator TESTER. We will get to that in another question later.

Mr. SILVERS. As my written testimony suggests, I think there is a basic problem with the world Gramm-Leach-Bliley created, which is that you have institutions that have large regulated, insured businesses and large unregulated, uninsured businesses, and they interact with each other unavoidably. That is an unsustainable situation.

Senator TESTER. So Gramm-Leach-Bliley needs to be changed in that particular area?

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Mr. SILVERS. I think that we need to decide whether we wish to basically really rein in our investment banks in a pretty heavy way, recognizing that under Gramm-Leach-Bliley they have all become bank holding companies, or that we want to have them run pretty aggressively and separately from insured deposits.

Senator TESTER. OK.

Mr. POZEN. I think that is a separate complex issue. To eliminate no documentation loans sold to the secondary market, Congress should amend the law that was passed last summer for the registration of mortgage lenders. They are still left mainly to the oversight of the States. We need a stronger Federal presence in mortgage lending.

And we need a very simple rule: You cannot sell more than 90 percent of any loan into the secondary market.

Senator TESTER. OK.

Mr. POZEN. If sellers were required to hold on to 10 percent of the loan, they would care more about the soundness of that loan. Not just the documents; they would care whether actually the borrower could pay.

Mr. LITAN. All three of us agree on that issue.

Senator TESTER. We have a situation right now where we have—I do not know—I think there are 17 banks that are too big to fail. Maybe more than that?

Mr. POZEN. Who knows?

Senator TESTER. The question for me becomes if they are too big to fail and at some point in time the money is going to run out, what do we do about that, long-term?

Mr. SILVERS. Senator, do you mean what do we do about the fact that there are banks that are too big to fail or what do we do about the fact that some of them are unstable right now?

Senator TESTER. Well, both. I mean because I think anytime you have a situation where you are too big to fail that means you cannot fail. That means that is an inherent problem. If you are too big to fail, you have a problem.

Mr. SILVERS. Senator, in the Congressional Oversight Panel's report, one of the reasons we recommended that you not identify who is too big to fail and who is not is so that you can have a continuous ratchet process around your capital requirements and your insurance costs that make it more and more expensive to be too big to fail. The result would be to encourage less too big to fail institutions.

The question of what do we do with the ones that are sick right now is that we need to take whatever steps are necessary to get them back to life in a way that is responsible with the taxpayers' money because we have a situation now where the four largest banks have more than 50 percent of the lending ability and they are paralyzed.

Senator TESTER. Yes.

Mr. LITAN. So I agree with Mr. Silvers that there ought to be higher capital charges progressively for larger institutions. Ditto for liquidity. That would introduce a penalty, if you will, for getting too large, and is it appropriately so because they visit costs on the rest of the system so that they ought to pay for it.

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The only area where I disagree, and I have said this before, is that once you introduce that system, given the disclosure requirements we have, everyone will know who these institutions are and you will not be able to keep it secret.

Senator TESTER. OK.

Mr. POZEN. Can I just add one more thing?

Senator TESTER. Yes.

Mr. POZEN. You should realize that our merger and acquisition policy now is creating more institutions that are too big to fail. We have been encouraging mergers and acquisitions among banks. Although Bank of America was too big before, we have now made it even bigger with Merrill Lynch. If Bank of America was too big to fail before, it is now much too big to fail.

We are also guaranteeing the debt of most banks.

Senator TESTER. Trust me. That is the whole problem. But what do we need to do to stop it?

Mr. POZEN. I think the first thing we should do is start guaranteeing only 90 percent of the debt of all these banks and related institutions; investors should hang on to a little risk. We want the big bond-holders at these banks, thrifts, and holding companies to help us police the financial situation and managerial quality of these institutions.

We tell any bank, you issue a billion dollars of debt and whoever owns it, it is 100 percent insured by the Federal Government, then the bond holders will not care who is running the bank or how it is being run.

Mr. LITAN. I just want to be clear on the debt. I think Mr. Pozen and I agree on this, that it is really the long-term debt where we want people to be on the hook. I think it is impractical in my own view to say that for deposits.

Mr. POZEN. Yes, I agree.

Mr. LITAN. So we are talking about long-term.

Mr. POZEN. We are now out to 10 years.

Senator TESTER. I understand that.

Mr. SILVERS. Senator, there is one final point about this, though. If you say here are five banks or here are 20 banks, and they are the systemically significant ones, what happens when the one right outside the list fails?

In a situation like we have today, in a crisis, it will turn out that somebody you thought was actually not systemically significant is systemically significant. Witness Bear Stearns and Lehman Brothers. You want to have a system that everybody is in, where that bright line does not become so important.

And, second, if you follow the logic of what my two co-panelists said about who in the capital structure needs to be held responsible when things go wrong, the clear implication of that is that we obviously are insuring depositors. We have effectively insured commercial paper and the money markets that commercial paper backs up, but there are very powerful reasons why we should not be insuring long-term debt holders and particularly not equity holders. And there is absolutely no way to square that with how we have actually treated the stockholders and long-term bond holders of Citibank, Bank of America, and others.

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Senator TESTER. Well, thank you all for being here. We could have this discussion well into the evening. So, thank you very much.

Chairman LIEBERMAN. Thank you, Senator Tester. Great questions.

You have been a wonderful panel. I am just thinking, going to Prime Minister Brown now, you have basically said that it is not time for another Bretton Woods series of agreements and we cannot wait here in the United States. We have to take action ourselves. There is too much at risk for us, for our economy, and the truth is if we right ourselves it will help to right the rest of the world.

Sometime we will have you back when we have more time to ask what, if anything, you think the United States should be doing to connect to the rest of the world since obviously part of the reality we are living in is a remarkably global financial system. But no time for that today.

In terms of time, we are going to keep the record of the hearing open for 15 days if you want to supplement your testimony in any way or if Members of the Committee who were here or not here want to submit questions to you to be answered for the record.

I thank you a lot. You have really helped, I say for myself, educate me and clarify some questions. In the end, Senator Collins and my hope is that we will make a recommendation to our colleagues on the Banking Committee, essentially a recommended reorganizational chart with some descriptions underneath about what powers we think different elements of the financial regulatory system need to have to prevent a recurrence of what we are going through now.

With that, I thank you all very much, and the hearing is adjourned.

[Whereupon, at 10:45 a.m., the Committee was adjourned.]

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WHERE WERE THE WATCHDOGS? FINANCIAL REGULATORY LESSONS FROM ABROAD

THURSDAY, MAY 21, 2009

U.S. SENATE,
COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 2:03 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, McCaskill, and Collins.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. The hearing will come to order. Good afternoon, and a special welcome to our guests, three of whom have come from farther than normal to testify—and without being summoned here by force of law, I might add. So we are particularly grateful that you are here.

This is our Committee's third in a series of hearings examining the structure of our financial regulatory system; how that flawed structure contributed to the system's failure to anticipate and prevent the current economic crisis; and, most importantly, looking forward, what kind of structure is needed to strengthen financial oversight. You will note that I used the word "structure" at least three times here, and this is because that is the unique function and jurisdiction that our Committee has. We understand that the Banking Committee in particular is leading the effort to review regulations in this field, but we are charged with the responsibility to oversee the organization of government, and we have tried to come at this matter of financial regulatory reform with a focus on that as opposed to the particular regulations.

We learned from our previous hearings that our current regulatory system has evolved in a haphazard manner, not just over the 10, 20, or 30 years some of us have been here, but over the last 150 years, largely in response usually to whatever the latest crisis was to hit our Nation and threaten its financial stability.

As a result, we have here a financial regulatory system that is both fragmented and outdated. Numerous Federal and State agencies share responsibility for regulating financial institutions and markets, creating both redundancies in some ways and gaps in others—gaps particularly over significant activities and businesses, and redundancies, too, such as consumer protection enforcement,

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hedge funds, and credit default swaps. Our current crisis has clearly exposed many of these problems.

To strengthen our financial regulatory system, an array of interested parties—academics, policymakers, even business people—from across the political spectrum has called for significant structural reorganization. So as we move forward and consider this question, it seemed to Senator Collins and me that it would be very helpful for us to examine the experiences of other nations around the world, and that is the purpose of today's hearing and why we are so grateful to the four of you.

Over the past few years, the United Kingdom, Australia, and other countries have dramatically reformed their financial regulatory systems. They have merged agencies, reconsidered their fundamental approaches to regulation, and streamlined their regulatory structures. Many people believe that these reforms have resulted in a more efficient and effective use of regulatory resources and certainly more clearly defined roles for regulators.

The American economy is different in size, of course, and in scope from all the others, but there is still much we can learn by studying the examples of these free market partners of ours. We really have an impressive panel of witnesses today, each of whom has not only thought extensively about the different ways in which a country can structure its financial regulatory system, but also played a role in that system. And I would imagine that you all bear some scars from trying to change the regulatory status quo.

I would also imagine that you know what we have learned here, that reorganizations are complicated and very difficult. Our Committee learned this firsthand through its role in creating and overseeing the Department of Homeland Security and in reforming our Nation's intelligence community in response to the terrorist attacks of September 11, 2001. But reorganizations can also pay dividends and result in a more effective, responsive, efficient, and transparent government, and of course, that is what we hope for in the area of financial regulation.

I am confident in the work that our colleagues on the Senate Banking Committee are doing to address the financial regulations, but as I said at the outset, we are focused here on structure, and the two are clearly tightly interwoven. If we want to minimize the likelihood of severe financial crises in the future, we need to both reform our regulations and improve the architecture of our financial regulators. As Treasury Secretary Geithner and the Obama Administration prepare to announce their own plan for comprehensive reform in the weeks ahead, the testimony presented here today will help ensure that we are cognizant of what has and has not worked abroad, and that surely can help us guide our efforts and the Administration's and clarify for us all which reforms, regulatory and structural, will work best here in the United States of America.

Senator Collins.

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Chairman, as you mentioned, this is the third in a series of hearings held by our Committee to examine America's financial cri-

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sis, and I commend you for your leadership in convening this series of hearings because I believe that until we reform our financial regulatory system, we are not going to address some of the root causes of the current financial crisis. Our prior hearings have reviewed the causes of the crisis and whether a systemic risk regulator and other reforms might have helped prevent it.

Testimony at these hearings has demonstrated that, for the most part, financial regulators in our country failed to foresee the coming financial meltdown. No one regulator was responsible for the oversight of all the sectors of our financial market, and none of our regulators alone could have taken comprehensive, decisive action to prevent or mitigate the impact of the collapse. These oversight gaps and the lack of attention to systemic risk undermined our financial markets. Congress, working with the Administration, must act to help put in place regulatory reforms to help prevent future meltdowns like this one.

Based on our prior hearings and after consulting with a wide range of financial experts, in March, I introduced the Financial System Stabilization and Reform Act. This bill would establish a Financial Stability Council that would be charged with identifying and taking action to prevent or mitigate systemic threats to our financial markets. The council would help to ensure that high-risk financial products and practices could be detected in time to prevent their contagion from spreading to otherwise healthy financial institutions and markets.

This legislation would fundamentally restructure our financial regulatory system, help restore stability to our markets, and begin to rebuild the public confidence in our economy. The concept of a council to assess overall systemic risk has garnered support from within the financial regulatory community. The National Association of Insurance Commissioners, the Securities and Exchange Commission (SEC) Chair Mary Schapiro, and the Federal Deposit Insurance Corporation (FDIC) Chair Sheila Bair are among those who support creating some form of a systemic risk council in order to avoid an excessive concentration of power in any one financial regulator, yet take advantage of the expertise of all the financial regulators.

As we continue to search for solutions to this economic crisis, it is instructive for us to look outside our borders at the financial systems of other nations.

The distinguished panel of witnesses that we will hear from today will testify about the financial regulatory systems of the United Kingdom, Canada, and Australia. They will also provide a broader view of global financial structures. We can learn some valuable lessons from studying their best practices. Canada's banking system, for example, has been ranked as the strongest in the world, while ours is ranked only as number 40.

I am very pleased that Edmund Clark has joined the other experts at the panel. It was through a meeting in my office when he started describing the differences between the Canadian system of regulation, financial practices, and mortgage practices versus our system that I became very interested in having him share his expertise officially, and I am grateful that he was able to change his schedule to be here on relatively short notice. I am also looking for-

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ward to hearing from the other experts that we have convened here today.

America's Main Street small businesses, homeowners, employees, savers, and investors deserve the protection of an effective regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk taking, and improves oversight, accountability, and transparency. This Committee's ongoing investigation will continue to shed light on how the current crisis evolved and focus attention on the reforms that are needed in the structure and regulatory apparatus to restore the confidence of the American people in our financial system. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Collins. Thanks for that thoughtful statement.

Let us go to the witnesses now. First we welcome David Green, who was Head of International Policy at the United Kingdom's Financial Services Authority (FSA) after having previously spent three decades at the Bank of England. Mr. Green currently works for England's Financial Reporting Council. It is an honor to have you here, and we would invite your testimony now.

TESTIMONY OF DAVID W. GREEN,[1] FORMER HEAD OF INTERNATIONAL POLICY, FINANCIAL SERVICES AUTHORITY, UNITED KINGDOM

Mr. GREEN. Thank you, Chairman. I give testimony, of course, as a private individual, having worked in those institutions you described. I also give testimony as a co-author with Sir Howard Davies of a book on global financial regulation which discusses a lot of the issues that are before the Committee today. The views expressed here are entirely my own, of course, and not those of any of the organizations I have been associated with.

There is remarkable biodiversity in arrangements for financial regulation at a global level. There are essentially four main types of structure to be found, with multiple variants. There is the sectoral type, with separate regimes for banking, securities, and insurance, which can be found in France, Italy, or Spain. There is the so-called "twin peaks" type to be found in Australia or, in alternative versions, in Canada and the Netherlands; the integrated type, which can be found in Germany, Japan, Scandinavia, and, indeed, in the United Kingdom. Then there is perhaps another fourth type, where the United States might fit, with extraordinary diversity.

When I was in the FSA, we thought we probably had over a hundred counterpart regulatory bodies in the United States.

Then there is the role of the central bank, which may or may not have responsibility for some, many, or, indeed, all aspects of supervision, as it does in Singapore, for instance.

Probably the most advanced form of the integrated regulator can be found in the FSA, where it was created remarkably rapidly when the incoming Labour Government simply decided in 1997, without real debate, that at the same time as giving the Bank of England independence in the implementation of monetary policy, it

[1] The prepared statement of Mr. Green appears in the Appendix on page 311.

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would also create a single regulator for financial services. That was set in train and eventually subsumed 11 prior agencies, and a single new piece of legislation was drafted completely de novo with new objectives for regulation and with a set of principles drafted to guide the regulators.

Not all of integrated regulators have that single piece of legislation, and they carry on with sectoral legislation. That is obviously an issue to be thought about when the Committee addresses the legislative structure that is put in place.

The bodies were merged in a way which enabled prior existing bodies simply not to be visible anymore. There was full integration. You cannot find within the regulator the bodies that were there before, and that was quite deliberate so that no impression should be created of one of the prior entities somehow taking over the others.

The rationale for integrated regulation was set out by the FSA, and in my written testimony, I set out the main arguments, but the core ones, as you know, are that financial conglomerates, in particular, undertake a range of banking, insurance, and investment business. The markets themselves have instruments which mingle features of all those. And it was difficult to carry on regulating on a purely functional basis when that no longer matched the structures of either firms or markets.

Integration makes it possible to align the regulatory structure with the way the firms manage themselves so that this should help with the proper understanding of the overall business model and of overall risks. It also means that a regulated firm only needs to deal with one agency for all its regulatory business, ideally through relationship managers on both sides.

An integrated regulator ought to be able to manage the conflicts which inevitably arise between the different objectives of regulation, and we will no doubt discuss that later. The concept underlying a single regulator is that these conflicts exist but need to be managed in one place or another, and there have been in the United Kingdom adverse experiences in the management of those conflicts in the past, which is one of the reasons why the intention was to put them together.

As regards the role of the central bank, there are a number of issues about the possible conflict of interest which might take place with the independent conduct of monetary policy. Monetary policy might be tempted to look more after the regulated community than the wider interest. And those arguments are a little bit more difficult to be certain about.

How has the model stood up? Previously, the model was very widely praised. Since the crisis, like of regulators in many places, there has been very wide criticism. But much of the criticism can be pinned down to failures, if you like, at the global level with the international capital rules regarded as having fallen short. Markets were inadequately understood. The way securitization would work and how markets would behave was very widely misunderstood. That has been a common problem. The FSA also made mistakes in not doing what it was supposed to do, simple internal management mistakes.

There has been a lot of work done to go over the lessons of the crisis. Both the FSA and the Bank of England have undertaken

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work to see whether the structure of regulation has identified any patterns of superior models as a result of the crisis, and no patterns have been found. The Bank of England did do some work—which I think I can make available to the Committee—which finds no pattern at all as between integrated, prudential, twin peaks regulator, and sectoral regulator. I think the conclusion has been that the model itself is not really seen to have been implicated in the way the crisis unfolded, and, indeed, the fact that banking, securities, and insurance were all interlinked in the crisis in some people's minds has reinforced the underlying concept.

Obviously, I would be very happy to answer further questions as the hearing proceeds. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you. That was most interesting and a good beginning. So at this state, we would say that, in your opinion, which one of these regulatory systems was chosen did not have much of an effect on the economic crisis that occurred.

Mr. GREEN. That appears to be the case. You can find a number of examples, if you take them in isolation, which reinforce a particular argument. But if you look across the board, you do not find a pattern. The Bank of England work that I referred to, which I am sorry I do not have available here, looked at, I think, about 40 or 50 different jurisdictions and could find no pattern related to structure.

Chairman LIEBERMAN. Yes.

Mr. GREEN. And the FSA work has shown that there have been problems when supervision was inside the central bank and when it was outside, and, again, no clear pattern can be found.

Chairman LIEBERMAN. That is interesting. I normally would hold the questions until after everyone testifies and then I come back. That does not mean that there are not preferences for one over the other form of regulation.

I also wanted to thank you for your graciousness in describing the American system as "diversified." That was nicely done. [Laughter.]

Second we have Dr. Jeffrey Carmichael, the inaugural chairman of the Australian Prudential Regulation Authority, with responsibility for regulating and supervising banks, insurance companies, and pension funds. Dr. Carmichael currently works in Singapore as the Chief Executive Officer (CEO) of Promontory Financial Group Australasia.

Thank you for being here.

TESTIMONY OF JEFFREY CARMICHAEL, PH.D.,[1] CHIEF EXECUTIVE OFFICER, PROMONTORY FINANCIAL GROUP AUSTRALASIA

Mr. CARMICHAEL. Thank you, Chairman, and let me say what a pleasure it is to be here.

Our government implemented a new structure in the middle of 1998. Unlike the experience that Mr. Green just referred to where the United Kingdom Government did it very quickly, ours was the outcome of a committee that sat for almost 12 months looking at

[1] The prepared statement of Mr. Carmichael appears in the Appendix on page 318.

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the options, and it was a great privilege for me to have been a member of that committee.

The new structure that was put in place realigned a previous structure a little bit like your own. It was an institutionally based structure. It was a hybrid structure of bits and pieces. We had State regulation as well as Federal regulation. What came out of the reorganization is what has become known as an "objectives-based" or a twin peaks type model. We do not like the term twin peaks because we actually have four peaks, so we think that is undercounting.

But the four agencies that were put in place were:

First, a competition regulator that sat over the entire system, not only the financial sector but the whole economy;

Second, a securities and investments commission, think of a combination of your SEC and the futures regulator. They had responsibility across all financial sectors for conduct, including financial institutions, markets, and participants;

The third was the Australian Prudential Regulation Authority (APRA), the one with which I was involved. We had responsibility for the prudential soundness of all deposit taking, insurance, and pensions;

And the fourth was the central bank, which was given, of course, systemic responsibility for monetary policy, liquidity support, and regulation of the payment system.

Over the top of that was a coordinating body, called the Council of Financial Regulators, which includes the Department of Treasury as well, and that is a very important add-on.

The defining characteristic of this architecture—and I should add this is in some ways very similar to your plan that was proposed by Former Treasury Secretary Henry Paulson earlier in 2008, but with a couple of important differences, which we can talk about later—is that it was unique in the world at the time it was put in place in Australia, and so far as we know, only one country—and that is the Netherlands—would claim to have the same structure in totality. The Canadian structure is similar, but a little bit less consistent.

The Australian banks under this structure, for example, are subject to all four regulators. They have competition covered by the Australian Competition and Consumer Commission (ACCC), their conduct by the Australian Securities and Investments Commission (ASIC), their prudence by APRA, and if there is a liquidity support or payment system issue, they go to the Reserve Bank. So that is the defining characteristic of this model, that multiple agencies are responsible for each institution, but for a different part of their behavior or their activities. And there is a fairly clear dividing line between those activities.

Some of the advantages that we see in this structure—and some of these, of course, are shared by other models such as the British one—include:

First, by assigning each regulatory agency to a single objective—that is either competition or prudence—it avoids the conflict of objectives that you face under virtually any other system. So each regulator has just one thing to worry about, and that avoids getting

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into some of the issues, for example, that Northern Rock brought out, for the FSA.

Second, in bringing all regulators of a particular objective together, you get synergies. We learned a lot when we brought banking and insurance regulation together, and we were able to develop an approach that took on the best of both of those systems and to develop synergies out of that. Likewise, ASIC, our conduct regulator, was one of the first in the world to introduce a single licensing regime for market participants.

Third, this structure helped eliminate regulatory arbitrage or jurisdiction shopping of the type that you have seen here. Prior to the creation of APRA there were at least three different types of institutions that could issue deposits in Australia, and they were subject to nine different regulatory agencies, depending on where they were located.

Following its creation, APRA introduced a fully harmonized regime. We now have a single class of "deposit-taking institutions." We do not distinguish between banks, credit unions, or thrifts. They can take on that separate identity, but they are all regulated as deposit takers.

Fourth, by bringing together all of the prudentially regulated institutions under the one regulatory roof, we have a more consistent and effective approach to regulating financial conglomerates, and along with countries like the United Kingdom and Canada, Australia has been at the forefront of developing the approach to conglomerate supervision.

Fifth, allocating a single objective to each regulator minimizes the overlap between agencies and the inevitable turf wars that are associated with that, which I am sure you are very familiar with.

Interesting for us in our experience was that the gray areas between the agencies have tended to diminish over time rather than to increase, and I think that has been a little bit of a surprise, but a very welcome surprise to those of us who were involved with the design.

Sixth, the allocation of a single objective to each agency minimizes cultural clashes, and one of the issues that we were very conscious of in creating the distinction between prudential and conduct regulation was that, while conduct regulation tends to be carried out by lawyers, prudential regulation tends to be carried out in general by accountants and finance and economics experts—with the exception of the United States, where lawyers tend to do it all. So, culturally, we found it was very useful to separate these two types of regulators so that we did not have those cultural battles.

Finally, by streamlining our old state-based, or partly state-based, regulatory system, we got a lot of cost efficiencies out of it, and we were able to facilitate strong financial sector development and innovation without having to reduce safety and soundness in the process.

In terms of outcomes, our architecture has weathered the recent financial storm better than most. Indeed, I believe our four major banks are still among the few AA-rated banks left in the world.

The resilience of our system was helped by exceptionally tough prudential standards, particularly in the areas of capital and

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securitization. There was also inevitably some good luck as well as good management. I am not going to claim it was all brilliance.

In terms of crisis management, the coordination arrangements worked exceptionally well and, I am told, in speaking with each of the agencies recently, that they found the singularity of objectives helped them enormously in terms of coordination among the different agencies in the crisis.

On the less positive side, like everyone else, we have learned that regulators and industry know much less about risk than we thought we did. We have had to think about the way risk is measured and regulated. Most importantly, we have learned that financial stability regulation is a much bigger challenge than we thought it was, and there is a lot still to be learned there. And to borrow the Churchillian phrase, we regulators have learned that "we have much about which to be modest."

In concluding, Mr. Chairman, I would like to offer two very general observations. The first echoes a point you made in your opening statement. There can be little dispute that regulatory architecture matters. It is very important. There is no perfect architecture. There is no one size fits all. But there are certainly some architectures that are virtually guaranteed to fail under sufficient pressure.

That said, architecture is only half the story. A sound architecture is a necessary but not a sufficient condition for effective regulation. The other component, which you mentioned, is how you implement and enforce those regulations, and it is very important that these two components are considered in tandem and not in isolation.

Finally, it is easier to tinker with the architecture than to do major reform. Major reform is largely about opportunity. The window for reform is usually only open very briefly. You have, arguably, the widest window for reform since the Great Depression. This crisis provides you with the public support and, I believe, the industry acquiescence to challenge the vested interests and inertia that normally make major reform of the type you have seen in some other countries all but impossible. And I am sure I speak for many of my colleagues in the international regulatory community, in hoping that this opportunity is not lost. Thank you.

Chairman LIEBERMAN. Thank you very much. Well said. I have many concerns, but one clearly is that the result of this crisis will be that we will change some regulations, some law, but we will not change the regulatory structure very much because of the resistance of those in the financial communities but also, frankly, here in Congress to changing the status quo. So your words are very much on target. I thank you.

Our third witness is Dr. Edmund Clark, President and CEO of the TD Bank Financial Group in Canada. Mr. Clark has had a long and distinguished career in both the Canadian Government and private industry, and we are very grateful that you are here today. Please proceed.

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TESTIMONY OF W. EDMUND CLARK, PH.D.,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, TD BANK FINANCIAL GROUP

Mr. CLARK. Thank you, Mr. Chairman and Ranking Member Collins, for inviting me, and thank you to the other Members. I am obviously not here as a regulatory expert, but we have a wonderful panel.

I am going to speak much more as a CEO who operates under the regulatory regimes. We are a little unusual in the sense that we operate on both sides of the border in Canada and the United States. We have over 1,000 branches in the United States from Maine to Florida, and we are a bank in the United States that is continuing to lend, and lend aggressively. So we have double-digit lending growth, and we are one of the few AAA-rated banks left in the world. We exited the structured products area in 2005, the source of most of the problems.

I thought I would comment on a couple of things, and one was the actual management of the crisis from the beginning of August 2007 until now, and I think what certainly distinguished the Canadian system, which may not be duplicable in larger countries, is that the six banks plus the Bank of Canada, the Office of the Superintendent of Financial Institutions (OSFI), and the Department of Finance essentially worked almost continuously together and have a shared objective. There was a very strong feeling among us that if any one of our banks ran into trouble, we would all run into trouble. So there was no attempt by one bank to, in a sense, game the system, and there was also fairly quickly a view that we should try to have a private sector solution to this problem, not a public sector solution; and to the extent we involved the public sector, it should be a profitable involvement on behalf of the taxpayers, not a subsidy, and we were able to successfully do that.

In terms of the structure of the industry, I think it is well known that there are some important differences. All the major dealers are owned by the Canadian banks, and we did, in fact, absorb $18 billion (CAD) of write-offs by these dealers. TD Bank did not have any significant write-offs, but $18 billion (CAD) is a significant amount in the size of Canada, but they were able to absorb that because they were tied to large entities with very stable retail earnings.

Second, the mortgage market is completely different in Canada. It is concentrated in the top banks, and we originate mortgages to hold them. And so we have resisted attempts—frankly, political attempts—to have us loosen standards because we are going to bear the risks of those loosened standards. So you did not get the development in Canada of what you did in the United States.

Third, in terms of the capital requirements, our capital requirements have always been above world standards, with a particular emphasis on common equity. But it has also been reinforced by the insistence of our regulation that we have our own self-assessment of how much capital we need, and that in all cases, it caused Canadian banks to hold more than regulatory minimums, not at regulatory minimums.

[1] The prepared statement of Mr. Clark appears in the Appendix on page 326.

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I think the other difference would be that our regime's binding constraint is risk-weighted assets, and that is a key feature why we hold our mortgages rather than sell them. Where you have total asset tests, you, in fact, encourage banks to sell low-risk assets, and where we have a total asset test is not the binding constraint.

In terms of the nature of the regulatory regime, it is a principles regime, not a rule-based regime—it is rather light in terms of the actual number of people employed in the regulatory regime. There is a high focus on ensuring that management and the board know and understand the risks that the institution is taking and that, in fact, they are building the infrastructure to monitor and manage that risk.

The way I put it internally in my organization is I am actually on the side of the regulator, not on the side of the bank. We have the same interest in ensuring that the bank does not run into trouble, and do you have less of this conflict situation because I see the regulator as helping me manage the bank.

I think another important element that Canada moved to in terms of compensation some time ago was to have low cash bonuses. So in my case, 70 percent of my pay would be in the form of equity which I hold. I am required to hold my economic interests in the bank for 2 years after I retire, so I cannot cut and run. And all my executives, whether in the wholesale side of the bank or the retail side of the bank, are paid on the whole bank's performance, including its ability to deliver great customer satisfaction. We also have separation of the chairman from the CEO, and all board and committee meetings have meetings without management present to ensure that independence.

Clearly, the issue, I think, you are addressing is the issue of systemic risk, and I think it is the toughest issue to deal with here. I think I would have to be in the camp to say all the systemic risk issues were well known and well talked about. It is not as if there was this mystery out there that the U.S. mortgage system was, in fact, going way up the risk curve and doing what most bankers would have regarded as crazy lending. It is not as if there was not meeting after meeting among bankers around the world about the risks that are inherent in structured products. And I would say the under-saving feature of the U.S. economy was a well-known fact. And so I think you do have to sit back and say, well, if these risks were well known, why were there no, in a sense, forces against that?

I can comment on our own experience. As I indicated, we did actually exit these products. We exited them because they were hard to understand. They embedded tail risk and added a lot of complexity to the organization. We also refused to, in fact, distribute the asset-backed paper program that blew up in Canada on the basis that if I would not sell it to my mother-in-law, I should not sell it to my clients.

But the real issue is that in doing that, that was a very unpopular thing to do. It was unpopular within my bank. It was unpopular among my investors. It is very hard to run against these tides, and so I think when you are talking about systemic risk, you have to recognize that there is this odd confluence of political, economic, and profit force actually always propelling it. It is like a lot of the

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literature, what creates boom. You have the same thing behind any forces of systemic risk.

So what is my conclusion as a practicer in the field? Well, I do not think there is one answer because, as I have said, banks have failed under most regulatory regimes. But I do think a strong regulator is important, and you certainly should not allow regulatory shopping. I think that is obviously a very bad thing.

And while rules are important, I actually think principles do matter. It was clear throughout the industry that people were in the process of using regulatory capital arbitrage, and if you sat there from a principle point of view, I think you might have stopped it.

Leadership matters enormously. I think boards should be held accountable to ensure that they actually have a CEO with the right value system. His job is to preserve the institution. And I think it is clear to say while all regulatory regimes may have known about systemic risk, they did not focus on systemic risk. And I think we are lacking mechanisms where, if you did come upon a view that existed, how would you, in fact, coordinate action to bring it to an end?

I do think going forward, though, there is also a risk that we could overreact, and one of the things I would plead is that many elements of the regulatory reforms could drive institutions to take more risk rather than less risk. And I think you have to be careful in your rules to make sure that low-risk strategies, such as the TD Bank one, are not, in fact, negatively impacted by some of the rule changes. Thank you very much.

Chairman LIEBERMAN. Thank you very much. Refreshing. I must say, I did not know how different the regulatory system and some of the rules of behavior were, and it is striking that one of the reasons that Canada did not get into some of the same mortgage problems as we did was really because of regulation, some of the things you were prohibited from doing.

Mr. CLARK. Right. There was an element of regulation that prohibited us, but also we had a capital regime that said we could hold low-risk assets and not have large amounts of capital. And that is a critical feature to the originate-and-hold model.

Chairman LIEBERMAN. Thank you.

Our final witness this morning is from closer to home. David Nason was at the Treasury Department during March 2008 and before and was very active in the construction of the Treasury Department's March 2008 "Blueprint for a Modernized Financial Regulatory Structure," previously known as "the Paulson plan." Mr. Nason is now the Managing Director for Promontory Financial Group here in Washington, DC. We have two of the four witnesses from the Promontory Group. That speaks well for the group.

Mr. Nason, we welcome your testimony.

TESTIMONY OF DAVID G. NASON,[1] MANAGING DIRECTOR, PROMONTORY FINANCIAL GROUP, LLC

Mr. NASON. Thank you for having me. Chairman Lieberman, Ranking Member Collins, and Members of the Committee, thank

[1] The prepared statement of Mr. Nason appears in the Appendix on page 334.

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you for inviting me to appear before you today on these important matters. As the United States begins to evaluate its financial regulatory framework, it is vital that it incorporate the lessons and experience from other countries' reform efforts.

I recently, as you just mentioned, finished a 3-year stint at the U.S. Department of the Treasury where I was honored to serve former Secretaries Jon Snow and Henry Paulson. And as the Assistant Secretary of the Treasury for Financial Institutions, I worked hand in hand with the government as they tried to respond to the financial crisis. More germane to this particular hearing is I am particularly proud to have led the team that researched and wrote the Treasury's "Blueprint for a Modernized Financial Regulatory Structure," which was published in March 2008. And many of the issues that we evaluated in the writing of the Blueprint are before the Congress and the focus of this hearing.

What seems clear as we think about this issue is that financial institutions play an essential role in a large part of our U.S. economy, and given the economic significance of the sector, it is important that we examine the structure of our regulatory framework as we think about the content of regulations. And this is all the more pressing as the United States begins to emerge from the current financial crisis.

The root causes of the financial crisis are well documented. Benign economic conditions and plentiful market liquidity led to risk complacency, dramatic weakening of underwriting standards for U.S. mortgages, especially subprime mortgages, and a general loosening of credit terms of loans to households and businesses.

The confluence of many events led to a significant credit contraction and a dramatic repricing of risk. We are still living through this process right now, and we have seen more government intervention in the financial markets than we have seen in decades.

The focus of this hearing today is prospective, however, and the financial crisis has told us that regulatory structure is not merely an academic issue and that topics like regulatory arbitrage matter and have meaningful repercussions outside of the province of academia. Indeed, if we look for something positive in the aftermath of the crisis, it might be that it will give us the courage to make the hard choices and reform our financial regulatory architecture.

We have learned all too well that our regulators and regulations were not well positioned to adapt to the rapid financial innovation driven by capital mobility, deep liquidity, and technology. Regulation alone and modernized architecture could not have prevented all of the problems from these developments. But we can do much better, and we can position ourselves better.

Our current regulatory structure in the United States no longer reflects the complexity of our markets. This complexity and the severity of the financial crisis pressured the U.S. regulatory structure, exposing regulatory gaps as well as redundancies. Our system, much of it created over 70 years ago, is grappling to keep pace with market evolutions and facing increasing difficulties, at times, in preventing and anticipating financial crises.

Largely incompatible with these market developments is our current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial

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services, such as banking, insurance, securities, and futures, with no single regulator possessing all of the information and authority necessary to monitor systemic risk.

Moreover, our current system results in duplication of certain common activities across regulators. Now, while some degree of specialization might be important for the regulation of financial institutions, many aspects of financial regulation and consumer protection regulation have common themes.

So as we consider the future construct of our U.S. financial regulation, we should first look to the experience of other countries, especially those that have conducted a thoughtful review recently, like we have heard today. As global financial markets integrate and accounting standards converge, it is only natural for regulatory practices to follow suit. There are two dominant forms of financial regulatory regimes that should be considered seriously in the United States as we rethink our regulatory model. I would like to focus on the consolidated regulator approach and the twin peaks approach.

Under a single consolidated regulator approach, one regulator responsible for both financial and consumer protection regulation would regulate all financial institutions. The United Kingdom's consolidation of regulation within the FSA exemplifies this approach, although other countries such as Japan have moved in this direction. The general consolidated regulator approach eliminates the role of the central bank from financial institution regulation, but preserves its role in determining monetary policy and performing some functions related to overall financial market stability.

A key advantage of the consolidated regulator approach that we should consider is enhanced efficiency from combining common functions undertaken by individual regulators into one entity. A consolidated regulator approach should allow for a better understanding of overall risks to the financial system.

While the consolidated regulator approach benefits are clear, there are also potential problems that we should consider. For example, housing all regulatory functions related to financial and consumer regulation in one entity may lead to varying degrees of focus on these key functions. Also, the scale of operations necessary to establish a single consolidated regulator in the United States could make the model more difficult to implement in comparison to other jurisdictions.

Another major approach, adopted mostly notably by our colleagues at the table in Australia and in the Netherlands, indeed, is the twin peaks model that emphasizes regulation by objectives. One regulatory body is responsible for prudential regulation of relevant financial institutions, and a separate and distinct agency is responsible for business conduct and consumer protection. The primary advantage of this model is that it maximizes regulatory focus by concentrating responsibility for correcting a single form of market failure—one agency, one objective. This consolidation reduces regulatory gaps, turf wars among regulators, and the opportunities for regulatory arbitrage by financial institutions, while unlocking natural synergies among agencies. And perhaps more importantly, it reflects the financial markets' extraordinary integration and

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complexity. It does pose a key problem in that effective lines of communication between the peaks are vital to success.

There are several ideas in circulation in the United States. I would like to focus on some things that we focused on in the Treasury Blueprint in 2008 and some other relevant policymakers that are talking about other ideas.

The March 2008 Blueprint proposes that the United States consider an objectives-based regulatory framework, similar to what Dr. Carmichael discussed, with three objectives: Market stability regulation, prudential regulation to address issues of limited market discipline, and business conduct regulation. Prudential regulation housed within one regulatory body in the United States can focus on the common elements of risk management across financial institutions, which is sorely lacking in the United States. Regulators focused on specific objectives can be more effective at enforcing market discipline by targeting of financial institutions for which prudential regulation is most appropriate.

Secretary of the Treasury Geithner and FDIC Chair Bair addressed similar issues of importance in dealing with too-big-to-fail institutions and the necessity of providing systemic risk regulation. Senator Collins, you introduced legislation that recognizes the key aspects that need to be addressed in our system to deal with these difficult problems.

So while there is an emerging consensus in the United States and among global financial regulators, market participants, and policymakers that systemic risk regulation and resolution authority must be a cornerstone of reform financial regulation, the exact details of the proposals need to be settled. These are very complicated and they require thoughtful debate and deliberation.

One point, however, is clear: The U.S. regulatory system, in its current form, needs to be modernized and evolved. We should seize upon this opportunity to do this. To this end, the future American regulatory framework must be directed towards its proper objectives to maintain a stable, well-capitalized, and responsible financial sector.

Thank you for inviting me.

Chairman LIEBERMAN. Thanks, Mr. Nason. Very helpful.

A vote just went off, but I think we are going to try to do a kind of tag team here, so Senator Collins will go over now, and I will ask questions, and then we will go on from there. The testimony has been very interesting.

While your testimony is in my mind, Mr. Nason, just take a moment, and if we went to the twin peaks here—although as Dr. Carmichael said, there are actually four in Australia—what would be under the two peaks?

Mr. NASON. Well, I said the twin peaks model, but essentially we would be asking for three peaks.

Chairman LIEBERMAN. Three, really.

Mr. NASON. Three peaks in the United States.

Chairman LIEBERMAN. One being the Federal Reserve.

Mr. NASON. One would be market stability regulation, which we recommend in the Blueprint would be housed at the Federal Reserve.

Chairman LIEBERMAN. Right.

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Mr. NASON. One would be prudential regulation of institutions that require prudential regulation for your banks and your insurance companies. And then business conduct regulation, which is the type of consumer protection regulation that we historically see in the consumer aspects of the Federal Reserve and the banking agencies and most of what the Securities and Exchange Commission does.

Chairman LIEBERMAN. So you would split up some of the existing regulatory agencies' functions, so it is not as simple as asking which agencies would go under which, because you would take pieces of each.

Mr. NASON. Yes, the model in the United States, it is a difficult way to think about it, but if you take the consumer elements of the banking agencies, put them under the business conduct regulator, take the bulk of the responsibilities of the SEC, put them under the business conduct regulator, and leave the prudential or financial regulation in a separate regulatory body, those are the two peaks. And then I think there is an important role that is not demonstrated in those two peaks: Someone taking the ownership of systemwide risks, and that is the important role that we give to the Federal Reserve in our Blueprint.

Chairman LIEBERMAN. Incidentally, I like the Paulson plan's use of the words "market stability regulator" because I think it is more clear than systemic regulator, which always confuses me at least.

Mr. NASON. We spent an enormous amount of time debating that, and I am glad you noticed it. The one reason we called it "market stability" is to indicate to everyone that you are going to have bouts of instability, and the goal is to try to keep the markets as stable as possible. But you cannot prevent it.

Chairman LIEBERMAN. Right. Let me ask Mr. Green, Dr. Carmichael, and Dr. Clark, from outside the United States looking in—acknowledging that we have heard some mixed testimony here on the question I am about to ask—and based on your experience, obviously, what role do you think the fragmented nature of our current structure played in the extent of the current economic crisis here in the United States? Can you make a judgment on that, Mr. Green?

Mr. GREEN. I think the most striking example—and there are several—was the AIG affair, where, of course, there was no Federal jurisdiction, as you know, which meant that although there was a lead regulator in the New York State Insurance Commission, nevertheless, that jurisdiction was shared with a lot of other regulators. And the Office of Thrift Supervision (OTS) also had a role, and I think it is fairly clear and widely acknowledged that this meant there were gaps in terms of looking at the whole picture for a global firm.

Chairman LIEBERMAN. Right.

Mr. GREEN. The other example I think relates to the U.S. investment banks, which almost uniquely at the global level were not regulated along with the rest of the banking system. And that led to gaps or inconsistencies. They were not—although they did business that was very similar——

Chairman LIEBERMAN. To banks.

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Mr. GREEN [continuing]. To banks and, indeed, in the rest of the world was done in banks. Nevertheless, they had a quite different capital regime, and, indeed, curiously, their consolidated capital regime was voluntary. That, of course, came to an end very abruptly over a weekend. This was a risk that a lot of people knew was waiting to be crystallized. But those are two big examples, if you like.

Chairman LIEBERMAN. So those are examples that suggest that structure had some kind of causal effect, or at least enabling effect on the crisis.

Dr. Carmichael, what would you say? And they are good examples, I think.

Mr. CARMICHAEL. I do not have a lot to add to that because I think it is spot on. If one had to put rough percentages on it—and this has got no science—I would say it was enabled 70 percent by the structure and 30 percent by bad regulation. So I think the structure actually had more to do with the problem.

I will add one example to what Mr. Green said. I was interested in one regulatory response to AIG—regulated, of course, by the State regulator. The State regulator said, "We now want to regulate credit default swaps as an insurance product," and immediately the impossibility of that became apparent in that, unless the other 49 States agreed to do it, the business would just move over the border. And this is not a national border. It is just moving across the Hudson River, for example.

So the insurance regulatory structure enables arbitrage, enables gravitation to the lowest common denominator. Like Mr. Green, we were amazed when we found that AIG was regulated by OTS as a conglomerate. That just seems ludicrous. So I agree entirely.

Chairman LIEBERMAN. Thanks. Dr. Clark.

Mr. CLARK. I guess what I would say I would not get yourself trapped that if you cannot take a direct link back to the great financial crisis, you should not clean it up. And so I would say the U.S. system obviously has a lot of issues that, even if they did not create the great financial crisis, certainly do not make the system run any better. And so I think whether you have 100 regulators or 50 does not matter. There is clearly regulatory shopping that goes on constantly in the United States, and that cannot be a good thing to have a sound system.

Chairman LIEBERMAN. That is a very important point. We are focused on this now because of the current crisis, and there are some clear linkages, as Mr. Green and Dr. Carmichael said. But there are obviously other reasons beyond that to want to alter our structure, and that is one of them—regulatory shopping.

What else? You made a reference in your gracious and diplomatic use of the term "diversified." I presume that underneath that was some sense that it was really pretty hard to work together with the United States because of the way in which the regulatory system was so dispersed?

Mr. GREEN. Certainly for regulators in the rest of the world—and Mr. Carmichael will have a view on this as well. Leave aside this AIG problem, even in the banking field there was no single voice in the United States. Although a case can be made for regulatory competition in this kind of area, it is not very clear where the ad-

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vantages came from regulatory competition, and certainly in international discussions, it is very difficult to have a completely coherent discussion when there are three or four counterparties in some discussions even about capital. And the SEC, if it was not there, should have been there.

Chairman LIEBERMAN. Right.

Mr. GREEN. It makes it very difficult to come to international consensus.

Chairman LIEBERMAN. Yes, and obviously we are in—to say the obvious—a global economy, and there are times when we want to have interactions globally that are not facilitated by the way in which we are organized. So I take your point.

I am going to have to go in a minute, but, Mr. Nason, from the U.S. perspective, are there any negative effects for American business in a global economy that result—or even domestically, but particularly globally—from this fractured system we have now?

Mr. NASON. Sure. The clearest and easiest example—sorry to beat it to death—is insurance. There are two things that are clear. One, the international community does not understand and appreciate the State regulatory system for insurance, so that American industry is not well represented around the globe. And, second, in periods of crisis like this, we learned all too well at the Treasury that we would be benefited significantly by having a Federal expert in insurance that you can draw upon for expertise.

One of the big problems associated with dealing with the AIG failure is there is no Federal person responsible for that industry, so you cannot draw on Federal expertise. And that was a very significant consequence of having this fractured system.

Another example we mentioned is the Office of Thrift Supervision, which has oversight responsibilities for the holding companies of a lot of these institutions, but does not have the appropriate stature to represent the thrifts around the world. So it is an inequality that hurts the institutions that have thrifts in this structure.

Chairman LIEBERMAN. Thank you.

I am going to ask that we stand in recess. As soon as Senator Collins comes back, I will ask the staff to please encourage her to begin her questioning.

The hearing is recessed.

[Recess.]

Senator COLLINS [presiding]. The hearing will come back to order. Senator Lieberman has graciously allowed me to temporarily assume the role of Chairman and reconvene the hearing so that we can keep proceeding through this vote.

I want to thank each of you for your very interesting testimony and bring up several issues in the hopes that I am not repeating too much of what the Chairman may have already asked you.

Mr. Carmichael, you talked about the four peaks, as you described it, and that some of the advantages were that each focuses on one aspect. You avoid conflict. You have essentially a functional regulatory approach. And then you said there is also a council of regulators. Does that council of regulators have responsibility for identifying systemic risk?

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Mr. CARMICHAEL. In a short answer, yes. But, more importantly, their role is to communicate and coordinate between the agencies and to make sure that there is a regular testing of issues. Sometimes the central bank, if it is concerned about a systemic issue, has the power to send some of its staff with the prudential people going on inspections, for example, to learn more about what some of those issues might be. The involvement of the Treasury is there for exactly the systemic type reason.

So while it does not have any direct authority—there is no charter that gives it the power to do anything—through coordination they are able to focus the issues and decide, for example, do we need more information about a particular area? Do we need one of the agencies to collect that on behalf of the systemic regulator?

Senator COLLINS. Mr. Nason, I know you were very involved in the Paulson Blueprint for reform, and I very much appreciated your insights. As I understand it, the Blueprint that Secretary Paulson put out did call for a systemic risk regulator, but it would be vested in, I believe, the Federal Reserve. Is that correct?

Mr. NASON. Yes.

Senator COLLINS. When you were involved in drafting the Blueprint, was consideration given to the council approach?

Mr. NASON. It was not labeled the "council approach," but one thing we did consider was providing more authority to the President's Working Group on Financial Markets, which is very similar to the council approach. We thought about it very seriously because there is a lot of elements of attractiveness to having a council because you are bringing a lot of different sets of expertise to bear.

One of the things we got tripped up on is providing the right amount of authority, and we were worried about clarity of purpose and clarity of mission among a council. But it is certainly something that we considered seriously.

Senator COLLINS. Mr. Clark, is there a system for identifying systemic risk in Canada?

Mr. CLARK. The system, I think, would be very similar, as I understand from Dr. Carmichael, to the Australian system. There is a group that meets regularly that is chaired by the Deputy Minister of Finance and would have our regulator, OSFI, on it and would have the Bank of Canada on it and the Canada Deposit Insurance Corporation (CDIC), the equivalent to the FDIC, on it. And, in fact, they have now created two committees—one which is called the Financial Institutions Supervisory Committee (FISC), which is designed more to deal with low-level coordination issues, and then a second one that deals with more explicitly strategic issues. And I think it is probably fair to say that as a result of this crisis, the role of that committee in making sure that they are debating what the systemic risk is and who is doing what about it has been elevated as a result of this.

Senator COLLINS. Mr. Green, what about in Great Britain? How is systemic risk handled?

Mr. GREEN. There is a so-called tripartite committee which brings together the Bank of England—the central bank—the FSA, and the Treasury, which was intended to look at the functioning of the system as a whole. And the Bank of England had a mandate in relation to the stability of the system as a whole.

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I think there was insufficient clarity about just what that meant in the original drafting and what that meant in terms of the role of the Bank of England—which, in fact, leaves a bit of a question in my mind in relation to the so-called Paulson Blueprint. The central bank has, as the monetary authority, the capacity to lend and to change monetary policy. But then there is an issue about what other tools does it have? Does it have the capacity then to instruct the regulators to take action on grounds of systemic risk?

I think, in fact, in the United Kingdom, the Bank of England did not think that it had that authority. And the way the system worked, the lack of clarity of objectives in retrospect proved a bit of a disadvantage. And the Bank of England spent its time talking about the economy, and the FSA spent its time thinking about the individual firms. And one of the main lessons that has been learnt from the crisis is that the regulator needs to think more about what is happening in the wider economy, and the central bank needs to remember that monetary policy only has effect through the financial system.

So it is quite a subtle set of links that is difficult to get precisely right.

Senator COLLINS. I think those are excellent points.

Mr. Nason, obviously one of the failures of our system was a failure to identify high-risk products that escaped regulation and yet ended up having a cascade of consequences for the entire financial system. And I am thinking in particular of credit default swaps, which in my mind were an insurance product, but they were not regulated as an insurance product. They were not regulated as a securities product. They really were not regulated by anyone.

And as long as we have bright financial people, which we always will, we are going to have innovation and the creation of new derivatives, new products.

One of my goals is to try to prevent these what I call "regulatory black holes" from occurring where a high-risk practice or product can emerge and no one regulator in our system has clear authority over it. Without a council, there is nobody to identify it and figure out who should be regulating it.

What are your thoughts on preventing these regulatory gaps?

Mr. NASON. I think there is a lot to like about what you are trying to achieve in your legislative proposal. I think that identifying the fact that credit default swap (CDS) and over-the-counter (OTC) derivative contracts are a source or a potential source of systemic risk is very important, and I am really happy to see you have identified it here and the Administration is thinking about ideas like putting them on exchanges and things like that, because OTC derivatives were typically not regulated because they were viewed as bilateral contracts between sophisticated parties. But they grew so big and they are so significant in the U.S. system that they proved to be two things: One, a source of great opaqueness in financial institutions where you could not get a sense of how important the derivative book was to a particular institution; and, two, a real channel for the too-interconnected-to-fail problem.

So I think that you are certainly right to identify them as something that needs to be looked at carefully. I think that they are certainly something that should be under the supervision, oversight,

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and jurisdiction of a council or a systemic risk regulator. And I think that I am happy that things are moving along in that way.

Senator COLLINS. Mr. Clark, I admire your foresight in deciding that some of these derivative products were simply not well understood and were too high risk in getting out of that market. In Canada, however, was there regulation of credit default swaps and those kinds of exotic derivatives? Or did the regulation only come about through safety and soundness regulations? If you understand what I am saying.

Mr. CLARK. I think so. In a sense, it was safety and soundness, and I think it is fair to say as we were exiting the business, Canadian banks were going into the business. So it was not as if our regulator was saying do not do this.

Senator COLLINS. That is what I was wondering.

Mr. CLARK. And as I pointed out earlier, Canadian banks collectively took $18 billion (CAD) in writedowns. So in U.S. terms, that is $180 billion, given the size of the country, so it is not an insignificant amount. So we cannot stand here and say there are no problems in Canada. I think that would be a misnomer.

I think this is a very difficult area because I think the reality is that people were aware of this and they were aware that the products were getting bigger and more complex. But as we were talking during the break, the reality is that people were making a lot of money on it, and it looked like it was very profitable. And I would say in its initial evolution, credit derivatives were actually a positive factor, and so for us as a bank, we were able to lay off a significant amount of our risk by buying credit protection, and in that sense we saw it as a good thing, not a bad thing. And it is only as a later evolution that in a sense it ended up causing, I think, some of the problems.

I think it underscores the capability issue, the one we talked earlier about AIG, that in this war, if you will, or race for knowledge, you have a very profitable and highly sophisticated industry in the banking system around the world. I think it does mean that you cannot afford to have three or four regulators trying to go up the scale of knowledge. You do have to have a concentrated knowledge in order to attract the people to try to have a counter-push to these ideas.

Senator COLLINS. Mr. Carmichael, any thoughts on how to prevent regulatory black holes as new products emerge?

Mr. CARMICHAEL. Two things I would add to the comments made so far. First of all, having banking and insurance under the one regulator, as is the case in Canada, Australia, and the United Kingdom, gives your regulator a much better chance to pick up where those risks are being laid off. And you look at the United States where you have 50 State insurance regulators, picking that up as a problem for AIG was much more difficult than it would have been under the other architectures.

The other side of it that I would add is that in a structure where you have a clear conduct regulator and that regulator has a responsibility for markets, that is where the primary responsibility for new markets, which is where new products tend to spring up. Regardless of how the market is conducted, whether bilateral or on an organized exchange, conduct should be the responsibility of that

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particular regulator, provided they have the mandate and the skills to pick that up and do with it what they need to. That is where you would get the primary regulation, the disclosures, the aggregation of information, and so on for those markets.

Senator COLLINS. Thank you. Senator McCaskill.

OPENING STATEMENT OF SENATOR MCCASKILL

Senator MCCASKILL. Thank you.

I do not know if you can help, Mr. Nason, but I have had a hard time figuring out how we missed all this. And you were at the Treasury Department for the 3 years prior to when we came this close to a global meltdown as it relates to our credit markets. And, I guess I am curious as to why you think no one at Treasury—I mean, I was in a room with Secretary Paulson, and I do not want to say that they were panicked, but there is a reason why there was such bipartisan support 40 days before our political election. If there was ever a time in this building that the two sides cannot get along, it would be 40 days before our national presidential elections. And when you had both major candidates for President voting in favor from both ends of the political spectrum, that was because we all had been given very detailed and accurate information about how close we were to completely falling off the table as it related to our credit markets.

I cannot get comfortable with how we are going to identify risk going forward if the best and the brightest in our country, supposedly the best financial minds in the world, did not see this coming. Can you help me?

Mr. NASON. I can try to help you. I do not have the answers, and we will be debating this for decades as to what actually happened. But I think there were a couple things that happened.

People saw individual things that they were worried about. The regulators knew that underwriting criteria had gone down for home mortgages. People had seen there was a very frothy housing market. People had seen that the covenants in debt were going down to a level that they were concerned with.

But I think what really was very surprising and what caught people off guard was the severity with which things went from being very frothy—people were not paying adequate attention to risk, so the pendulum was nobody cared about risk at all, people were just worried about making money—to people who were not willing to take risk at all. So there was just a complete and utter contraction of credit in the economy that caused an enormous contraction.

The speed with which that happened was something that people were not expecting. You got to a point where money center banks would not lend to each other for 20 days or for 10 days without paying exorbitant interest rates. So you had a complete breakdown in confidence. And I cannot give you comfort that we are going to find it again. I can give you comfort that this is that 1-in-100-year event. And you can try to manage it better, you can try to prepare yourself better, but this is one of those things where I do not think you can predict it. You can just put yourself in a better position to try to deal with it.

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Senator MCCASKILL. Which of the three parts of your plan would be responsible for identifying what happened?

Mr. NASON. Well, the three parts of the plan—first of all, the plan was not created to deal with the financial crisis. It was actually written before the financial crisis happened.

Senator MCCASKILL. You wrote it in March, right?

Mr. NASON. Well, we researched and wrote it the year going up to March, and we released it right after Bear Stearns failed, but it was not in response to those types of events.

Senator MCCASKILL. Right.

Mr. NASON. So the plan is not a lookback plan. But I think generally speaking, you would have coordination among the three parties to describe how to better position ourselves to deal with this better.

Senator MCCASKILL. Let us assume that instead of your plan being announced in March 2008—obviously, this is a fantasy—that Congress passed it whole cloth and it was in existence. Which is the body that you would expect under the plan that has been drawn up would be the one to say things are nuts, people are overleveraging, they have no idea what they are buying and selling, they are chasing a number, and it is all about greed?

Mr. NASON. Sure. I would tell you that each of the three would have a role, and here is what they would do. On the prudential side, there would be tightened standards for capital for financial institutions and more regulation on liquidity management. On the conduct side, there would be stronger regulations for mortgages and things like that. And on the market stability side, there would be more focus on the interconnectedness of these two institutions and also of things like the derivatives markets. Those would be three ways that each of the three pillars of the Paulson plan would respond to this.

Senator MCCASKILL. Is it possible that the three pillars of the Paulson plan, that each one of those pillars would have said it was their job?

Mr. NASON. No. That is actually one of the premises of the Paulson plan, is clarity of mission and clarity of objective. See, one of the problems that we dealt with was that there was a lot of finger pointing. There were battles between the State regulators versus the Federal regulators on who was in charge of mortgage origination. So there were concerns about who was in charge of the holding company of Lehman Brothers. Was it the OTS or the SEC?

So there is much less chance for finger pointing under an objectives-based criteria like the Dutch and the Australians have.

Senator MCCASKILL. Mr. Clark, I heard you say that you originate mortgages to hold them, and I keep explaining that one of my concerns about reverse mortgages that we are now ramping up in this country is that they are very similar to subprimes in that the people who are closing loans have no skin in the game. Now, the scary thing about reverse mortgages is that all of the skin is taxpayer skin. If those assets are sold at term and they are not sufficient to cover the loan, the Federal Government has to cover the loan. But in the subprime, it was all of these exotic sliced and diced derivatives that were spread out all over that we are trying, like Humpty-Dumpty, to put back together again now.

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I assume that in Canada the people who are holding the mortgage are the same ones who made them and, therefore, they continue to have skin in the game.

Mr. CLARK. Absolutely. We originate all the mortgages. We do not buy mortgages. We originate our own mortgages. And, therefore, we are very concerned about the underwriting standards because we are going to take the risks.

I do believe that the system of holding the mortgages does a couple of things for you. One, it means you have the banking system trying to make sure you have conservative risk, not wild risk. But, second, it actually gives us an asset. The way I always describe our bank is we are not an income statement that generates a balance sheet. We are a balance sheet that generates an income statement. And that means we have a solidity of earnings that is there because we are not originating mortgages, then selling them off, and then saying, well, where am I getting next year's income if we originate more and sell them off. We are actually holding them.

And so I think it produces tremendous stability in the system, but it does require a regulatory regime that does not penalize you for capital if, in fact, you hold a low-risk asset like that.

Senator MCCASKILL. Do you think we should have regulations that require people who close mortgages to assume some of the risk?

Mr. CLARK. I think some system where the people who originate have skin in the game is quite important.

Senator MCCASKILL. Mr. Nason, what do you think?

Mr. NASON. I think that what we have seen is that our securitization markets certainly got overheated, and there is certainly some merit——

Senator MCCASKILL. I think a bonfire is more like it.

Mr. NASON. I am not going to quibble with that. I think a bonfire is just fine. I do want to suggest, though, that the securitization market, it is a bad word right now and it is an ugly word, but it has a lot of value. It provides a lot of credit to the economy. A lot of markets depend on it. It is important to rebuild that market so we can get more credit in the economy. Today, the auto industry relies on it; a lot of industries rely on it. So it is important. Whether or not it overheated like a bonfire, I think that is a fair characterization.

Senator MCCASKILL. Would you mind if I ask one more question?

Chairman LIEBERMAN [presiding]. Go right ahead, Senator.

Senator MCCASKILL. I am a little uneasy about BlackRock. I know that BlackRock was called in to manage at the New York Federal Reserve in terms of some of the valuation of the assets, and I know that there is some valuation of assets and then there is going around to the other window and participating—and I keep hearing that BlackRock is the only game in town, and that is why they are getting all these contracts. Their name came up again yesterday in connection with the Pension Benefit Guaranty Corporation (PBGC), the guaranty fund for pensions in this country. I keep hearing that BlackRock is the only company that has the model and it is proprietary, and therefore, they are the only game in town, and we keep going back to BlackRock. In fact, I had somebody tell me that the Secretary of the Treasury talked more often

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to the head of BlackRock than probably a lot of other folks. And I do not know if that is true or not, but it worries me because of the—too big to fail aspect. Can I get you, without threat of torture, to give me your take on why BlackRock is all of a sudden everywhere and is involved in everything as it relates to sorting out our financial mess?

Mr. NASON. A couple of things. I cannot imagine that the comment that either Secretary of the Treasury spent more time talking to BlackRock than anyone else is accurate.

Senator MCCASKILL. Hyperbole.

Mr. NASON. Hyperbole. That is one thing.

The second thing is the determination of hiring BlackRock to manage the assets in the Maiden Lane/Bear Stearns situation, I think that was a decision made by the Federal Reserve, so that is not something I can speak about.

I think generally speaking what you are dealing with is a large risk transfer of assets from financial institutions to a variety of structures. And what the government is trying to do is to protect the U.S. taxpayers' interest, hire someone who has some experience in managing those particular assets. BlackRock, Western Asset Management Company (WAMCO), and the Pacific Investment Management Company (PIMCO)—there are a couple of people who are very experienced in that.

I do not know the specifics of that particular situation, but the only thing I can say is that there is a lot of oversight and regulation for this process. There are the procurement rules. There is the GAO and the TARP Inspector General that are making sure that policies and procedures are followed. So I think you can take comfort in the process surrounding how these asset managers are retained and the solicitations being made for them. That should give you comfort. I think there is a lot of transparency in that as well.

Senator MCCASKILL. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator McCaskill. Thanks for participating this afternoon.

We will do a second round insofar as Members want to be here or can be here.

The Paulson plan, the Treasury Department's plan, issued last March, as you probably know, envisioned a regulatory system similar to Australia's, which was objectives based. The report was controversial here, although, unfortunately, it got overwhelmed by the growing crisis, so it did not receive the discussion I think it deserved. But it called for consolidation and dissolution of some existing agencies.

One controversial reform, which we have referred to briefly here this morning, was the consolidation of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

I wanted to ask our three witnesses from outside the United States—I think I know the answer, but not totally—if any of the three countries divide the regulation of securities and futures the way we do here in the United States, or are they regulated under one roof? Mr. Green, everything is under one roof?

Mr. GREEN. Everyone is under one roof and, indeed, it was, I think, always under one roof before the great merger into the FSA.

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Chairman LIEBERMAN. Right.

Mr. GREEN. There was no real distinction between the primary markets and the derivative markets. And I must say—and I stand to be corrected by my colleagues here—I am not aware of any other country where there is such a distinction.

Chairman LIEBERMAN. Interesting. Correct, as far as you know, Mr. Carmichael?

Mr. CARMICHAEL. Yes, certainly in Australia, it has always been under the one roof. What changed after we restructured was that we also had brought it into one law. Prior to that, there had been a separate law for derivatives and for securities, and there were two separate exchanges. Once the law was merged, the two exchanges also merged, and it was just simply a recognition that there is no fundamental distinction there at all.

Chairman LIEBERMAN. Right. How about Canada?

Mr. CLARK. Well, unfortunately, we are the worst of all. We have multiple security regulators in Canada.

Chairman LIEBERMAN. Worse than the United States.

Mr. CLARK. Worse than the United States in this——

Chairman LIEBERMAN. That is very interesting.

Mr. CLARK [continuing]. One respect, I would have to say. So I think we are trying to get a national regulator.

Chairman LIEBERMAN. So is it——

Mr. CLARK. State level, essentially, and so this has been an industry for 40 years to try to get this problem solved. I think the current government is working very hard to see whether they can get this reformed and have a national regulator. But it has faced enormous political disagreement on it because of state rights, essentially. And so I would say that is, if we were looking for black holes in Canada, the fact that we do not have a national regulator. And if you take a look at the one major crisis Canada did have around asset-backed paper, certainly a contributing factor was that there was no federal regulation of this. This was all done at the provincial level and so escaped—so it was—I think it represents a black hole example.

Chairman LIEBERMAN. Mr. Nason, I take it that historically the reason we had both the SEC and the CFTC is that the CFTC grew up from the trading in agricultural commodities and they did not want to be mixed with the Wall Street regulators.

Mr. NASON. Historically, that is the genesis of the CFTC's creation in the 1970s. But, interestingly enough, when the CFTC was being created, Members of Congress and their staffs asked the SEC if they wanted the jurisdiction for agricultural commodities, and they declined because it was a specialized market.

Chairman LIEBERMAN. Right.

Mr. NASON. But now I think the volume of financial futures on the futures exchanges is well over 90 percent; whereas, in the 1970s it was significantly bifurcated between financial and agriculture.

Chairman LIEBERMAN. Yes. I think this has a lot of logic, but it is going to be, for those historical reasons, difficult here. And we can already see not just the regulated entities but the Members of Congress fighting for the status quo; that is, the Agriculture Committee fighting to keep a separate CFTC. Of course, Senator Collins

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and I think that is why this Committee has a unique role to play, because we have no vested interest on either side—at least not in this matter. We may in other matters.

Let me go on to ask Mr. Green, Dr. Carmichael, and Mr. Clark about what I would call transition challenges. As we are heading toward a time of reform, both regulatory and structural, I wonder if you could give us any counsel about transition problems that your countries faced, particularly the two of you, during the transition to a more consolidated regulatory system and any warnings you would give us as a result.

Mr. GREEN. We had a Big Bang in the United Kingdom under very unusual circumstances. It was not prepared by a great deal of discussion, but it was accepted almost without subsequent debate because so many parties thought that it solved a lot of prior problems. So there was, if you like, a consensus that the previous arrangements were unsatisfactory, and there were a lot of attractions in what was being done then.

There was a big advantage, though, in that because there was almost no warning, and the government was able to decide, using its parliamentary majority, that this would happen. The people just had to get on with it, and the organizations were thrown together and told they had to come up with a solution. There was not any alternative. You are not in that position in the United States.

I suppose the lesson that one would draw from it is that if it is at all possible to start with a structure that, rather as I said in my earlier remarks, does not have one organization clearly in the lead, but you are building a true merger and a new structure out of that, there may be a greater chance of success. But the historical circumstances were quite unusual in that respect.

Chairman LIEBERMAN. Dr. Carmichael, in addition to responding to that, I wonder if you would talk just a little bit about what the opinion is in Australia now about whether this was a good move to go to the so-called twin peaks, in the government, amongst the public, and I suppose in the regulated community.

Mr. CARMICHAEL. Anytime you have change, you are going to have some difficulty, and I have been through this not only twice in Australia with regulatory amalgamation, but in about half a dozen countries where I have worked as well. So I have seen some of the problems that can arise firsthand.

Two of the biggest ones are fear—and that is mainly among staff—fear for jobs, and fear for where they will end up in the new structure.

Chairman LIEBERMAN. Right.

Mr. CARMICHAEL. And the second is distraction. Regulators have a job to do, a day job, which is regulation, but they are distracted because of the reorganization and the rebuilding. So those are two very big considerations that you have to deal with in any change.

Chairman LIEBERMAN. Did previous agencies disappear, as I take it they did, in the United Kingdom?

Mr. CARMICHAEL. Some did.

Chairman LIEBERMAN. But some continued.

Mr. CARMICHAEL. Yes.

Chairman LIEBERMAN. They were just put into one of the peaks.

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Mr. CARMICHAEL. We plucked parts of the central bank and parts of some of the State regulators and put them together into a national regulator. We only had one major institutional rebuild. The others were sort of tinkered with at the edges. If reform happened here it would be a much more extensive rebuilding than that because of the sheer number of agencies that you have.

But there are two things that in my experience have been absolutely critical to getting to the end without falling over. First is leadership—we have found that if you identify the people who are going to be the leaders of the new organizations, you have to do that early and you have to put them in place to drive the changes because there are always people who will resist the change and undermine the process. You do not want them anywhere around when you are doing it. So there is a need to make the big decisions early on and then to get on with it.

The second one is communication—so that people understand what is happening, and they get involved with it. The more you can involve staff in the new structure, the more they will feel ownership for it and be a part of it.

I should mention two other things. Mr. Green mentioned Big Bang. In the United Kingdom, they did a Big Bang in terms of making the decision very quickly. In terms of moving to a new internal structure, the FSA moved in gradual steps over quite a long period of time. We used a very different approach. We just kept the agencies separate for a year. We brought them together in name but people kept doing their old jobs for that year. We redesigned how we wanted the agency to look at the end of that. And at the end of the first year, we basically sacked everyone and invited them to apply for new jobs in the new agency. And for 2 weeks I did not sleep, not knowing whether we would actually have an agency at the end of the process. I would not recommend that approach. It worked, but I would not recommend it for anyone else.

The last point I would make before getting to your comment about whether it was a success is about legal elements, and I speak here as a non-lawyer, but I have learned to respect law much more over the last 10 or 15 years than I ever did. It was a mistake in Australia to create the agency just with a piece of enabling legislation that set it up, said what its powers were, but left it to operate under each of the individual industry acts that were already in place. So we still had a banking act and a general insurance act and so on.

What we have done in a couple of other countries is take each of those pieces of legislation and, before creating the agency, take all of the regulatory powers out of those and move them up into the agency's act. The power of that is just incredible.

For example, when we first wanted to create a new governance standard for all of our industries, my lawyers said, "I am sorry, Chairman. You cannot do that. You have to issue it under each of the different pieces of legislation, and some of them do not even give you the power to do that."

So the ability to create a harmonized approach in Australia was severely handicapped by the law.

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Now, the United Kingdom went about it another way—they created an omnibus act. It was very painful, but the outcome was very strong.

So legal elements are important. I would encourage you, if you go this route, to get the legislation running ahead of the agency, if you can. Get the legal side sorted out so that the agency has the powers to do what it needs to do.

You asked whether it was a good move. The answer is undoubtedly, yes. Our Prime Minister in Australia and our Treasurer are out around the world crowing about how great our system has been. If you wound the clock back 2 years ago, they were still grumbling that the system belonged to their predecessors, who were of a different party. The story has changed enormously.

Chairman LIEBERMAN. That is powerful testimony. Thank you. Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Carmichael, let me take up where the Chairman left off. Your four peaks or twin peaks approach has a lot of appeal to me, but I am wondering, as someone who spent 5 years overseeing financial regulation in the State of Maine, how it works for the regulatory community. If you have separate regulators, do you also have separate compliance audits? In other words, in Maine, when we would send out our bank auditors to review the State-chartered banks for compliance, they did the entire audit because it was only that one agency plus there was a Federal agency involved as well. But if you have separate regulators for prudential regulation competition, are you having multiple audits?

Mr. CARMICHAEL. The answer is yes, but "multiple" is a very small number in that our prudential regulator has the primary responsibility for on-site inspections. And I should say we are much more of a principles-based than a rules-based country, so we do not do anything like as many audits and on-site inspections as would be common under the U.S. approach.

Our conduct regulator, which is the pillar that looks at mis-selling and mis-pricing of products, works on the basis of responding to complaints. So they are not out there auditing complaints as such. They will hear a complaint, and they are really looking for misconduct of a type. Then they will do an investigation. So it is very targeted. It is not a regular on-site audit of that style.

So in the sense of overlap, it is really quite minimal.

Senator COLLINS. I also recall when I was head of the Financial Department that we would have regulated entities say, well, we are going to consider becoming federally chartered unless you do X. So there is a real problem in our country with shopping for the easiest regulator and playing the States off against the Federal regulators and vice versa. And because that is an income stream to the regulator, those threats matter to State governments, particularly State governments that are strapped for funds. So I think that is an issue as well.

Mr. Nason, in the United States we now recognize that a large shadow banking sector can threaten the entire financial sector, and I, for one, believe that it is not enough to monitor just the safety and soundness of traditional banks, but we need to extend safety

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and soundness regulation to investment banks, for example, to subsidiaries of companies like AIG.

Bear Stearns, I am told, had an astonishing leverage ratio of 30:1 when it failed. Do you think that we should be extending some system of capital requirements across the financial sector?

Mr. NASON. That is a great and very difficult question. If you go back to Bear Stearns, Bear Stearns was under a consolidated supervisory system that was administered by the SEC, so they did have liquidity and capital requirements that were different than the banking system, but they were under some type of conglomerate supervision.

I think generally if you are a systemically important institution, it is hard to argue that you should not be under some type of systemic supervision to prevent hurting the general economy.

What gets harder is where do you draw the line between which types of institutions gets safety and soundness supervision and which do not? For example, a very easy case is some hedge funds, you can make an argument that they are systemically important because of their size or concentration in particular markets. They could probably be subjected to some type of supervision. Should all hedge funds be subjected to that type of supervision? The case is harder the smaller they become.

So the way that we cut it in the Blueprint is that institutions would all need to be licensed, chartered, and under the supervision of our systemic regulator. But that type of systemic regulation was different than traditional prudential safety and soundness regulation.

Senator COLLINS. It, of course, gets very complicated very quickly because if you designate certain financial institutions as systemically important and, thus, make them subject to safety and soundness regulation, you are also sending a message that they are too big to fail—a very bad message to send because then you are creating moral hazard.

This is so complicated to figure out the right answer here, but I do think it is significant that the Canadian banks, with their higher capital requirements and the ability to hold lower-return assets, lower-risk assets, and lower leverage ratios compared to American banks, were healthier. They did not fail. So, clearly, there has got to be a lesson for us there.

Mr. Clark, I know we are running out of time, but I do want to talk to you further about the lending practices. I completely agree with my colleague from Missouri that part of the problem with the American mortgage system was that risk and responsibility were divorced, so you had a mortgage broker who was making the loan, gets his or her cut, then sells it to the bank, which gets its cut, which then sells it to the secondary market. Everyone is getting a financial reward, but ultimately no one is responsible for the mortgage if it goes bad. There is no skin in the game, which I think is a big problem, although difficult to solve because of the liquidity issues that Mr. Nason raised.

But there are other key differences as well that you talked to me about when we were in my office, and they had to do with downpayment levels, mortgage insurance, and deductibility of interest.

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Could you discuss some of the differences between Canadian and American mortgage lending?

Mr. CLARK. Maybe I should just mention one other feature that I have not underscored but we found a tremendous difference on the two sides of the border. In Canada, because we hold all the mortgages, modifying the mortgages is easy to do. We do not have to ask anyone's permission to modify the mortgage. And it is not the government coming to us and saying, "Would you start? Here is our modification program." We just were instantly modifying the mortgages.

Last year, we represented about 20 percent of the mortgage market in Canada. We only foreclosed on 1,000 homes in a whole year, to give you an order of magnitude. And every one of those thousand we regarded as a failure. And so the last thing we would ever want to do is actually foreclose on a good customer. And so we go out of our way to modify the mortgages, and that is just natural practice for us because I do not have to ask permission of some investor whether or not I want to do this or can do it or what rules are governing it.

So I do think that has turned out in this crisis to be a second feature that, frankly, none of us would have thought about until the current crisis.

In terms of our specifics, we are required, if we, in fact, lend more than 80 percent loan-to-value, to actually insure the mortgage so that represents a constraint. It would not have represented a constraint to the kind of no documentation lending that was done in the United States because the actual underwriting we are doing. But then again, because we actually would be holding the mortgages, we insisted on full documentation.

There is not interest deductibility. I think there is no question that the feature of having interest deductibility in the United States is a major factor for leveraging up. And despite the fact that it is justified on the basis that it encourages homeownership, historically homeownership has actually been higher in Canada than it has been in the United States. So there is no evidence that the two are linked at all. All it does is inflate housing prices because, in fact, people look at the after-tax cost in computing the value on which they are to bid for the houses.

So I would say those are the main features. We do have mortgage brokers, but they are originating mortgages which we then hold. We do not sell them on. And I think that is the core feature.

Senator COLLINS. And just to clarify, in most cases the homebuyer is putting down 20 percent. Is that correct?

Mr. CLARK. Yes. Although when I started my first house, I bought the insurance and put down less than 20 percent. But you can do it. But, again, we would not lend to that person unless we were sure they were going to pay us back because we are responsible for the collections, we are responsible for managing that, and it is really our customer relationship, which is how we regard it.

Senator COLLINS. I think it is fascinating that homeownership levels are actually higher in Canada than in the United States, because the justification for all these policies that encouraged the subprime mortgage market was to increase homeownership. And, in fact, it has caused a lot of people to lose homes that they could

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not afford in the first place, and the Canadian experience is very instructive.

Mr. Green, last question to you. In the United Kingdom, what are the lending policies? Are they more similar to the Canadian practices or to the American practices?

Mr. GREEN. A mixture. There is also no interest deductibility in the United Kingdom, though that has not stopped a boom in house prices. There has been no regulation of the terms of lending, and one of the issues that has arisen in the review that the FSA has undertaken of what went wrong and what might need to change—which I commend to you, it is a very detailed review covering many of the issues we have talked about today—is whether there should be some kind of mandatory loan-to-value ratios or loan-to-income ratios. So they were not in place, but that is seriously being considered.

What has now been agreed at the European level is that there will be skin in the game and that the originator in securitization will have to maintain 5 percent. And I think I am right in saying that has now been legislated across the European Union because of a rather widespread perception that this was a problem that needed fixing. You may say 5 percent is only symbolic, but, of course, it will concentrate the minds of the management to all the issues that Dr. Clark has mentioned.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thanks very much, Senator Collins.

Thanks to our four witnesses. Thanks for the trouble you took to come here, for the time you spent with us, and, most of all, for sharing your experiences and opinions. I found this to be a very helpful hearing. Even you, Mr. Nason, who did not come that far. [Laughter.]

We appreciate your testimony. And at the risk of simplifying it, I think in various ways your testimony has shown us that structure matters, obviously regulation does, too, that you need a healthy combination of both, and that none is a cure-all. You cannot assume that a good regulatory structure will solve all the problems. But it will solve some of them, and it will prevent others from occurring or make it harder for others to occur. I think you have helped clarify opinions up here, so we thank you very much.

It is our normal course to keep the record of the hearing open for 15 days for any additional questions or statements. If you have any second thoughts you want to add to the printed record—all your prepared statements, which were excellent, will be printed in the record in full. It may be that some Members of the Committee, those who were here and those who were not, would file some questions with you, and if you have the chance, it would be appreciated if you would answer them for the record. But, really, our thanks, and I hope you will both watch with interest as we proceed to attempt to reform and say a prayer for us as well.

The hearing is adjourned. Thank you.

[Whereupon, at 4:01 p.m., the Committee was adjourned.]

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APPENDIX

United States Government Accountability Office

GAO

Testimony
Before the Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Wednesday, January 21, 2009

FINANCIAL REGULATION

A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

Statement of Gene L. Dodaro
Acting Comptroller General of the United States



GAO-09-314T

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our January 8, 2009, report that provides a framework for modernizing the outdated U.S. financial regulatory system.[1] We prepared this work under the authority of the Comptroller General to help policymakers weigh various regulatory reform proposals and consider ways in which the current regulatory system could be made more effective and efficient. My statement today is based on our report, which (1) describes how regulation has evolved in banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets and other important areas; (2) describes several key changes in financial markets and products in recent decades that have highlighted significant limitations and gaps in the existing regulatory system; and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, we synthesized existing GAO work and other studies and met with representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. The work upon which the report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008.

The report was enhanced by input from representatives of 29 agencies and other organizations, including federal and state financial regulatory agencies, consumer advocacy groups, and financial service industry trade associations, who reviewed and commented on a draft of the report prior to its release. A list of organizations that reviewed the draft report is included at the end of my statement. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

[1]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

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Summary

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. Today, almost a dozen federal regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies share responsibility for overseeing the financial services industry. As the nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the nation's needs in the 21st century.

Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system.

- First, regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks.
- Second, regulators have had to address problems in financial markets resulting from the activities of large and sometimes less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.
- Finally, as financial markets have become increasingly global, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

These significant developments have outpaced a fragmented and outdated regulatory structure, and, as a result, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has significant weaknesses that, if not addressed, will continue to expose

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the nation's financial system to serious risks. Our report offers a framework for crafting and evaluating regulatory reform proposals consisting of nine characteristics that should be reflected in any new regulatory system. By applying the elements of the framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

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Table 1: Framework for Crafting and Evaluating Regulatory Reform Proposals

Characteristic		Description
✓	Clearly defined regulatory goals	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
✓	Appropriately comprehensive	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
✓	Systemwide focus	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
✓	Flexible and adaptable	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
✓	Efficient and effective	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
✓	Consistent consumer and investor protection	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
✓	Regulators provided with independence, prominence, authority, and accountability	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.
✓	Consistent financial oversight	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
✓	Minimal taxpayer exposure	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO.

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the

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likelihood that the United States will experience another financial crisis similar to the current one.

Today's Financial Regulatory System Was Built over the Course of More Than a Century, Largely in Response to Crises or Market Developments

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. In particular, five federal agencies—including the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—and multiple state agencies oversee depository institutions. Securities activities are overseen by the Securities and Exchange Commission and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by the Commodity Futures Trading Commission and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little federal involvement. Other federal regulators also play important roles in the financial regulatory system, such as the Public Company Accounting Oversight Board, which oversees the activities of public accounting firms, and the Federal Trade Commission, which acts as the primary federal agency responsible for enforcing compliance with federal consumer protection laws for financial institutions, such as finance companies, which are not overseen by another financial regulator.

Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s. Changes in the types of financial activities permitted for depository institutions and their affiliates have also shaped the financial regulatory system over time. For example, under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services, but with the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities.

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Changes in Financial Institutions and Their Products Have Significantly Challenged the U.S. Financial Regulatory System

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 1.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulators have struggled, and often failed, to mitigate the systemic risks posed by these conglomerates, and to ensure they adequately manage their risks. The portion of firms that conduct activities across the financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.

A second dramatic development in U.S. financial markets in recent decades has been the increasingly critical roles played by less-regulated entities. In the past, consumers of financial products generally dealt with entities such as banks, broker-dealers, and insurance companies that were regulated by a federal or state regulator. However, in the last few decades, various entities—nonbank lenders, hedge funds, credit rating agencies, and special-purpose investment entities—that are not always subject to full regulation by such authorities have become important participants in our financial services markets. These unregulated or less regulated entities can sometimes provide substantial benefits by supplying information or allowing financial institutions to better meet demands of consumers, investors or shareholders, but pose challenges to regulators that do not fully or cannot oversee their activities. For example, significant participation in the subprime mortgage market by generally less-regulated nonbank lenders contributed to a dramatic loosening in underwriting standards leading up to the current financial crisis.

A third development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. In particular, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.

Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in

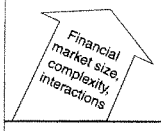
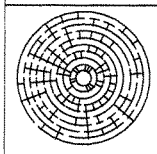
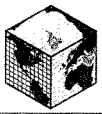
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addressing challenges arising from the global convergence of accounting and auditing standards.

Finally, with the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators. For example, the current system has complicated the ability of financial regulators to convey a single U.S. position in international discussions, such the Basel Accords process for developing international capital standards, and international officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making.

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Figure 1: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System

Developments in financial markets and products		Examples of how developments have challenged the regulatory system
	**Emergence of large, complex, globally active, interconnected financial conglomerates**	Regulators sometimes lack sufficient authority, tools, or capabilities to oversee and mitigate risks.
		Identifying, preventing, mitigating, and resolving systemic crises has become more difficult.
	**Less-regulated entities have come to play increasingly critical roles in financial system**	Nonbank lenders and a new private-label securitization market played significant roles in subprime mortgage crisis that led to broader market turmoil.
		Activities of hedge funds have posed systemic risks.
		Overreliance on credit ratings of mortgage-backed products contributed to the recent turmoil in financial markets.
		Financial institutions' use of off-balance sheet entities led to ineffective risk disclosure and exacerbated recent market instability.
	**New and complex products that pose challenges to financial stability and investor and consumer understanding of risks.**	Complex structured finance products have made it difficult for institutions and their regulators to manage associated risks.
		Growth in complex and less-regulated over-the-counter derivatives markets have created systemic risks and revealed market infrastructure weaknesses.
		Investors have faced difficulty understanding complex investment products, either because they failed to seek out necessary information or were misled by improper sales practices.
		Consumers have faced difficulty understanding mortgages and credit cards with new and increasingly complicated features, due in part to limitations in consumer disclosures and financial literacy efforts.
		Accounting and auditing entities have faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.
	**Financial markets have become increasingly global in nature, and regulators have had to coordinate their efforts internationally.**	Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards.
		Fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators, such as negotiations on Basel II and certain insurance matters.

Sources: GAO (analysis); Art Explosion (images).

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A Framework for Crafting and Assessing Alternatives for Reforming the U.S. Financial Regulatory System

As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. As early as 1994, we identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products.[2] Since then, we have described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs.[3] Our report offers a framework for crafting and evaluating regulatory reform proposals; it consists of the following nine characteristics that should be reflected in any new regulatory system. By applying the elements of this framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

1. ***Clearly defined regulatory goals.*** **A regulatory system should have goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.**

A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of a dynamic financial services industry is to clearly define regulatory goals and objectives. In the background of our report, we identified four broad goals of financial regulation that regulators have generally sought to achieve. These include ensuring adequate consumer protections, ensuring the integrity and fairness of markets, monitoring the safety and soundness of institutions, and acting to ensure the stability of the overall financial system. However, these goals are not always explicitly set in the federal statutes and regulations that govern these regulators. Having specific goals clearly articulated in

[2]GAO, *Financial Derivatives: Actions Needed to Protect the Financial* System, GAO/GGD-94-133 (Washington, D.C.: May 18, 1994).

[3]GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure,* GAO-05-61 (Washington, D.C.: Oct. 6, 2004); and *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure,* GAO-08-32 (Washington, D.C.: Oct. 12, 2007).

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legislation could serve to better focus regulators on achieving their missions with greater certainty and purpose, and provide continuity over time.

Given some of the key changes in financial markets discussed in our report—particularly the increased interconnectedness of institutions, the increased complexity of products, and the increasingly global nature of financial markets—Congress should consider the benefits that may result from re-examining the goals of financial regulation and making explicit a set of comprehensive and cohesive goals that reflect today's environment. For example, it may be beneficial to have a clearer focus on ensuring that products are not sold with unsuitable, unfair, deceptive, or abusive features; that systemic risks and the stability of the overall financial system are specifically addressed; or that U.S. firms are competitive in a global environment. This may be especially important given the history of financial regulation and the ad hoc approach through which the existing goals have been established.

We found varying views about the goals of regulation and how they should be prioritized. For example, representatives of some regulatory agencies and industry groups emphasized the importance of creating a competitive financial system, whereas members of one consumer advocacy group noted that reforms should focus on improving regulatory effectiveness rather than addressing concerns about market competitiveness. In addition, as the Federal Reserve notes, financial regulatory goals often will prove interdependent and at other times may conflict.

Revisiting the goals of financial regulation would also help ensure that all involved entities—legislators, regulators, institutions, and consumers—are able to work jointly to meet the intended goals of financial regulation. Such goals and objectives could help establish agency priorities and define responsibility and accountability for identifying risks, including those that cross markets and industries. Policymakers should also carefully define jurisdictional lines and weigh the advantages and disadvantages of having overlapping authorities. While ensuring that the primary goals of financial regulation—including system soundness, market integrity, and consumer protection—are better articulated for regulators, policymakers will also have to ensure that regulation is balanced with other national goals, including facilitating capital raising, innovation, and other benefits that foster long-term growth, stability, and welfare of the United States.

Once these goals are agreed upon, policymakers will need to determine the extent to which goals need to be clarified and specified through rules

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and requirements, or whether to avoid such specificity and provide regulators with greater flexibility in interpreting such goals. Some reform proposals suggest "principles-based regulation" in which regulators apply broad-based regulatory principles on a case-by-case basis. Such an approach offers the potential advantage of allowing regulators to better adapt to changing market developments. Proponents also note that such an approach would prevent institutions in a more rules-based system from complying with the exact letter of the law while still engaging in unsound or otherwise undesirable financial activities. However, such an approach has potential limitations. Opponents note that regulators may face challenges to implement such a subjective set of principles. A lack of clear rules about activities could lead to litigation if financial institutions and consumers alike disagree with how regulators interpreted goals. Opponents of principles-based regulation note that industry participants who support such an approach have also in many cases advocated for bright-line standards and increased clarity in regulation, which may be counter to a principles-based system. The most effective approach may involve both a set of broad underlying principles and some clear technical rules prohibiting specific activities that have been identified as problematic.

Key issues to be addressed:

- Clarify and update the goals of financial regulation and provide sufficient information on how potentially conflicting goals might be prioritized.
- Determine the appropriate balance of broad principles and specific rules that will result in the most effective and flexible implementation of regulatory goals.

2. ***Appropriately comprehensive.*** **A regulatory system should ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met. As such, activities that pose risks to consumer protection, financial stability, or other goals should be comprehensively regulated, while recognizing that not all activities will require the same level of regulation.**

A financial regulatory system should effectively meet the goals of financial regulation, as articulated as part of this process, in a way that is appropriately comprehensive. In doing so, policymakers may want to consider how to ensure that both the breadth and depth of regulation are

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appropriate and adequate. That is, policymakers and regulators should consider how to make determinations about which activities and products, both new and existing, require some aspect of regulatory involvement to meet regulatory goals, and then make determinations about how extensive such regulation should be. As we noted in our report, gaps in the current level of federal oversight of mortgage lenders, credit rating agencies, and certain complex financial products such as CDOs and credit default swaps likely have contributed to the current crisis. Congress and regulators may also want to revisit the extent of regulation for entities such as banks that have traditionally fallen within full federal oversight but for which existing regulatory efforts, such as oversight related to risk management and lending standards, have been proven in some cases inadequate by recent events. However, overly restrictive regulation can stifle the financial sectors' ability to innovate and stimulate capital formation and economic growth. Regulators have struggled to balance these competing objectives, and the current crisis appears to reveal that the proper balance was not in place in the regulatory system to date.

Key issues to be addressed:

- Identify risk-based criteria, such as a product's or institution's potential to harm consumers or create systemic problems, for determining the appropriate level of oversight for financial activities and institutions.
- Identify ways that regulation can provide protection but avoid hampering innovation, capital formation, and economic growth.

3. ***Systemwide focus.*** **A regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it is created.**

A regulatory system should focus on risks to the financial system, not just institutions. As noted in our report, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. The collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly,

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once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

Having a single entity responsible for assessing threats to the overall financial system could prevent some of the crises that we have seen in the past. For example, in its *Blueprint for a Modernized Financial Regulatory Structure*, Treasury proposed expanding the responsibilities of the Federal Reserve to create a "market stability regulator" that would have broad authority to gather and disclose appropriate information, collaborate with other regulators on rulemaking, and take corrective action as necessary in the interest of overall financial market stability. Such a regulator could assess the systemic risks that arise at financial institutions, within specific financial sectors, across the nation, and globally. However, policymakers should consider that a potential disadvantage of providing the agency with such broad responsibility for overseeing nonbank entities could be that it may imply an official government support or endorsement, such as a government guarantee, of such activities, and thus encourage greater risk taking by these financial institutions and investors.

Regardless of whether a new regulator is created, all regulators under a new system should consider how their activities could better identify and address systemic risks posed by their institutions. As the Federal Reserve Chairman has noted, regulation and supervision of financial institutions is a critical tool for limiting systemic risk. This will require broadening the focus from individual safety and soundness of institutions to a systemwide oversight approach that includes potential systemic risks and weaknesses.

A systemwide focus should also increase attention on how the incentives and constraints created by regulations affects risk taking throughout the business cycle, and what actions regulators can take to anticipate and mitigate such risks. However, as the Federal Reserve Chairman has noted, the more comprehensive the approach, the more technically demanding and costly it would be for regulators and affected institutions.

Key issues to be addressed:

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.

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- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.

4. ***Flexible and adaptable.*** **A regulatory system should be adaptable and forward-looking such that regulators can readily adapt to market innovations and changes and include a mechanism for evaluating potential new risks to the system.**

A regulatory system should be designed such that regulators can readily adapt to market innovations and changes and include a formal mechanism for evaluating the full potential range of risks of new products and services to the system, market participants, and customers. An effective system could include a mechanism for monitoring market developments—such as broad market changes that introduce systemic risk, or new products and services that may pose more confined risks to particular market segments—to determine the degree, if any, to which regulatory intervention might be required. The rise of a very large market for credit derivatives, while providing benefits to users, also created exposures that warranted actions by regulators to rescue large individual participants in this market. While efforts are under way to create risk-reducing clearing mechanisms for this market, a more adaptable and responsive regulatory system might have recognized this need earlier and addressed it sooner. Some industry representatives have suggested that principles-based regulation would provide such a mechanism. Designing a system to be flexible and proactive also involves determining whether Congress, regulators, or both should make such determinations, and how such an approach should be clarified in laws or regulations.

Important questions also exist about the extent to which financial regulators should actively monitor and, where necessary, approve new financial products and services as they are developed to ensure the least harm from inappropriate products. Some individuals commenting on this framework, including industry representatives, noted that limiting government intervention in new financial activities until it has become clear that a particular activity or market poses a significant risk and therefore warrants intervention may be more appropriate. As with other key policy questions, this may be answered with a combination of both approaches, recognizing that a product approval approach may be appropriate for some innovations with greater potential risk, while other activities may warrant a more reactive approach.

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Key issues to be addressed:

- Determine how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such a responsibility.

- Consider how to strike the right balance between overseeing new products as they come onto the market to take action as needed to protect consumers and investors, without unnecessarily hindering innovation.

5. ***Efficient and effective.*** **A regulatory system should provide efficient oversight of financial services by eliminating overlapping federal regulatory missions, where appropriate, and minimizing regulatory burden while effectively achieving the goals of regulation.**

A regulatory system should provide for the efficient and effective oversight of financial services. Accomplishing this in a regulatory system involves many considerations. First, an efficient regulatory system is designed to accomplish its regulatory goals using the least amount of public resources. In this sense, policymakers must consider the number, organization, and responsibilities of each agency, and eliminate undesirable overlap in agency activities and responsibilities. Determining what is undesirable overlap is a difficult decision in itself. Under the current U.S. system, financial institutions often have several options for how to operate their business and who will be their regulator. For example, a new or existing depository institution can choose among several charter options. Having multiple regulators performing similar functions does allow for these agencies to potentially develop alternative or innovative approaches to regulation separately, with the approach working best becoming known over time. Such proven approaches can then be adopted by the other agencies. On the other hand, this could lead to regulatory arbitrage, in which institutions take advantage of variations in how agencies implement regulatory responsibilities in order to be subject to less scrutiny. Both situations have occurred under our current structure.

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we note in our report, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part

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because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted in our report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

One first step to addressing such problems is to seriously consider the need to consolidate depository institution oversight among fewer agencies. Since 1996, we have been recommending that the number of federal agencies with primary responsibilities for bank oversight be reduced.[4] Such a move would result in a system that was more efficient and improve consistency in regulation, another important characteristic of an effective regulatory system. In addition, Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity. We have not studied the issue of an optional federal charter for insurers, but have through the years noted difficulties with efforts to harmonize insurance regulation across states through the NAIC-based structure. The establishment of a federal insurance charter and regulator could help alleviate some of these challenges, but such an approach could also have unintended consequences for state regulatory bodies and for insurance firms as well.

Also, given the challenges associated with increasingly complex investment and retail products as discussed earlier, policymakers will need to consider how best to align agency responsibilities to better ensure that consumers and investors are provided with clear, concise, and effective disclosures for all products.

Organizing agencies around regulatory goals as opposed to the existing sector-based regulation may be one way to improve the effectiveness of the system, especially given some of the market developments discussed earlier. Whatever the approach, policymakers should seek to minimize conflict in regulatory goals across regulators, or provide for efficient mechanisms to coordinate in cases where goals inevitably overlap. For example, in some cases, the safety and soundness of an individual

[4]See GAO, *Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure*, GAO/T-GGD-96-117 (Washington, D.C.: May 2, 1996).

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institution may have implications for systemic risk, or addressing an unfair or deceptive act or practice at a financial institution may have implications on the institution's safety and soundness by increasing reputational risk. If a regulatory system assigns these goals to different regulators, it will be important to establish mechanisms for them to coordinate.

Proposals to consolidate regulatory agencies for the purpose of promoting efficiency should also take into account any potential trade-offs related to effectiveness. For example, to the extent that policymakers see value in the ability of financial institutions to choose their regulator, consolidating certain agencies may reduce such benefits. Similarly, some individuals have commented that the current system of multiple regulators has led to the development of expertise among agency staff in particular areas of financial market activities that might be threatened if the system were to be consolidated. Finally, policymakers may want to ensure that any transition from the current financial system to a new structure should minimize as best as possible any disruption to the operation of financial markets or risks to the government, especially given the current challenges faced in today's markets and broader economy.

A financial system should also be efficient by minimizing the burden on regulated entities to the extent possible while still achieving regulatory goals. Under our current system, many financial institutions, and especially large institutions that offer services that cross sectors, are subject to supervision by multiple regulators. While steps toward consolidated supervision and designating primary supervisors have helped alleviate some of the burden, industry representatives note that many institutions face significant costs as a result of the existing financial regulatory system that could be lessened. Such costs, imposed in an effort to meet certain regulatory goals such as safety and soundness and consumer protection, can run counter to other goals of a financial system by stifling innovation and competitiveness. In addressing this concern, it is also important to consider the potential benefits that might result in some cases from having multiple regulators overseeing an institution. For example, representatives of state banking and other institution regulators, and consumer advocacy organizations, note that concurrent jurisdiction—between two federal regulators or a federal and state regulator—can provide needed checks and balances against individual financial regulators who have not always reacted appropriately and in a timely way to address problems at institutions. They also note that states may move more quickly and more flexibly to respond to activities causing harm to consumers. Some types of concurrent jurisdiction, such as enforcement authority, may

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be less burdensome to institutions than others, such as ongoing supervision and examination.

Key issues to be addressed:

- Consider the appropriate role of the states in a financial regulatory system and how federal and state roles can be better harmonized.
- Determine and evaluate the advantages and disadvantages of having multiple regulators, including nongovernmental entities such as SROs, share responsibilities for regulatory oversight.
- Identify ways that the U.S. regulatory system can be made more efficient, either through consolidating agencies with similar roles or through minimizing unnecessary regulatory burden.
- Consider carefully how any changes to the financial regulatory system may negatively impact financial market operations and the broader economy, and take steps to minimize such consequences.

6. ***Consistent consumer and investor protection.*** **A regulatory system should include consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements.**

A regulatory system should be designed to provide high-quality, effective, and consistent protection for consumers and investors in similar situations. In doing so, it is important to recognize important distinctions between retail consumers and more sophisticated consumers such as institutional investors, where appropriate considering the context of the situation. Different disclosures and regulatory protections may be necessary for these different groups. Consumer protection should be viewed from the perspective of the consumer rather than through the various and sometimes divergent perspectives of the multitude of federal regulators that currently have responsibilities in this area.

As discussed in our report, many consumers that received loans in the last few years did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate they had in recent years. In addition, increasing

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evidence exists that many Americans are lacking in financial literacy, and the expansion of new and more complex products will continue to create challenges in this area. Furthermore, regulators with existing authority to better protect consumers did not always exercise that authority effectively. In considering a new regulatory system, policymakers should consider the significant lapses in our regulatory system's focus on consumer protection and ensure that such a focus is prioritized in any reform efforts. For example, policymakers should identify ways to improve upon the existing, largely fragmented, system of regulators that must coordinate to act in these areas. This should include serious consideration of whether to consolidate regulatory responsibilities to streamline and improve the effectiveness of consumer protection efforts. Another way that some market observers have argued that consumer protections could be enhanced and harmonized across products is to extend suitability requirements—which require securities brokers making recommendations to customers to have reasonable grounds for believing that the recommendation is suitable for the customer—to mortgage and other products. Additional consideration could also be given to determining whether certain products are simply too complex to be well understood and make judgments about limiting or curtailing their use.

Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer protections, including suitability requirements and disclosures across the financial services industry.
- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how they are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.

7. ***Regulators provided with independence, prominence, authority, and accountability.*** **A regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly**

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accountable for meeting regulatory goals.

A regulatory system should ensure that any entity responsible for financial regulation is independent from inappropriate influence; has adequate prominence, authority, and resources to carry out and enforce its statutory mission; and is clearly accountable for meeting regulatory goals. With respect to independence, policymakers may want to consider advantages and disadvantages of different approaches to funding agencies, especially to the extent that agencies might face difficulty remaining independent if they are funded by the institutions they regulate. Under the current structure, for example, the Federal Reserve primarily is funded by income earned from U.S. government securities that it has acquired through open market operations and does not assess charges to the institutions it oversees. In contrast, OCC and OTS are funded primarily by assessments on the firms they supervise. Decision makers should consider whether some of these various funding mechanisms are more likely to ensure that a regulator will take action against its regulated institutions without regard to the potential impact on its own funding.

With respect to prominence, each regulator must receive appropriate attention and support from top government officials. Inadequate prominence in government may make it difficult for a regulator to raise safety and soundness or other concerns to Congress and the administration in a timely manner. Mere knowledge of a deteriorating situation would be insufficient if a regulator were unable to persuade Congress and the administration to take timely corrective action. This problem would be exacerbated if a regulated institution had more political clout and prominence than its regulator because the institution could potentially block action from being taken.

In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, in a 2007 report we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.[5] It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct

[5]GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007).

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their work effectively. A regulatory system should also include adequate checks and balances to ensure the appropriate use of agency authorities. With respect to accountability, policymakers may also want to consider different governance structures at agencies—the current system includes a combination of agency heads and independent boards or commissions—and how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals.

Key issues to be addressed:

- Determine how to structure and fund agencies to ensure each has adequate independence, prominence, tools, authority and accountability.
- Consider how to provide an appropriate level of authority to an agency while ensuring that it appropriately implements its mission without abusing its authority.
- Ensure that the regulatory system includes effective mechanisms for holding regulators accountable.

8. ***Consistent financial oversight.*** **A regulatory system should ensure that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally.**

A regulatory system should ensure that similar institutions, products, and services posing similar risks are subject to consistent regulation, oversight, and transparency. Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.

Streamlining the regulation of similar products across sectors could also help prepare the United States for challenges that may result from increased globalization and potential harmonization in regulatory

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standards. Such efforts are under way in other jurisdictions. For example, at a November 2008 summit in the United States, the Group of 20 countries pledged to strengthen their regulatory regimes and ensure that all financial markets, products, and participants are consistently regulated or subject to oversight, as appropriate to their circumstances. Similarly, a working group in the European Union is slated by the spring of 2009 to propose ways to strengthen European supervisory arrangements, including addressing how their supervisors should cooperate with other major jurisdictions to help safeguard financial stability globally. Promoting consistency in regulation of similar products should be done in a way that does not sacrifice the quality of regulatory oversight.

As we noted in a 2004 report, different regulatory treatment of bank and financial holding companies, consolidated supervised entities, and other holding companies may not provide a basis for consistent oversight of their consolidated risk management strategies, guarantee competitive neutrality, or contribute to better oversight of systemic risk.[6] Recent events further underscore the limitations brought about when there is a lack of consistency in oversight of large financial institutions. As such, Congress and regulators will need to seriously consider how best to consolidate responsibilities for oversight of large financial conglomerates as part of any reform effort.

Key issues to be addressed:

- Identify institutions and products and services that pose similar risks.
- Determine the level of consolidation necessary to streamline financial regulation activities across the financial services industry.
- Consider the extent to which activities need to be coordinated internationally.

9. ***Minimal taxpayer exposure.*** **A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.**

[6]GAO-05-61.

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A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. Policymakers should consider identifying the best safeguards and assignment of responsibilities for responding to situations where taxpayers face significant exposures, and should consider providing clear guidelines when regulatory intervention is appropriate. While an ideal system would allow firms to fail without negatively affecting other firms—and therefore avoid any moral hazard that may result—policymakers and regulators must consider the realities of today's financial system. In some cases, the immediate use of public funds to prevent the failure of a critically important financial institution may be a worthwhile use of such funds if it ultimately serves to prevent a systemic crisis that would result in much greater use of public funds in the long run. However, an effective regulatory system that incorporates the characteristics noted previously, especially by ensuring a systemwide focus, should be better equipped to identify and mitigate problems before it become necessary to make decisions about whether to let a financial institution fail.

An effective financial regulatory system should also strive to minimize systemic risks resulting from interrelationships between firms and limitations in market infrastructures that prevent the orderly unwinding of firms that fail. Another important consideration in minimizing taxpayer exposure is to ensure that financial institutions provided with a government guarantee that could result in taxpayer exposure are also subject to an appropriate level of regulatory oversight to fulfill their responsibilities.

Key issues to be addressed:

- Identify safeguards that are most appropriate to prevent systemic crises while minimizing moral hazard.
- Consider how a financial system can most effectively minimize taxpayer exposure to losses related to financial instability.

Finally, although significant changes may be required to modernize the U.S. financial regulatory system, policymakers should consider carefully how best to implement the changes in such a way that the transition to a new structure does not hamper the functioning of the financial markets, individual financial institutions' ability to conduct their activities, and consumers' ability to access needed services. For example, if the changes require regulators or institutions to make systems changes, file registrations, or other activities that could require extensive time to

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complete, the changes could be implemented in phases with specific target dates around which the affected entities could formulate plans. In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.[7] Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss these critically important issues and would be happy to answer any questions that you may have. Thank you.

Contacts

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[7]See GAO, *Homeland Security: Critical Design and Implementation Issues*, GAO-02-957T (Washington, D.C.: July 17, 2002).

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Appendix I: Agencies and Other Organizations That Reviewed the Draft Report

American Bankers Association
American Council of Life Insurers
Center for Responsible Lending
Commodity Futures Trading Commission
Conference of State Bank Supervisors
Consumer Federation of America
Consumers Union
Credit Union National Association
Department of the Treasury
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Federal Reserve
Financial Industry Regulatory Authority
Financial Services Roundtable
Futures Industry Association
Independent Community Bankers of America
International Swaps and Derivates Association
Mortgage Bankers Association
National Association of Federal Credit Unions
National Association of Insurance Commissioners
National Consumer Law Center
National Credit Union Administration
National Futures Association
Office of the Comptroller of the Currency
Office of Thrift Supervision
Public Company Accounting Oversight Board
Securities and Exchange Commission
Securities Industry and Financial Markets Association
U.S. PIRG

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Related GAO Products

Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. GAO-09-216. Washington, D.C.: January 8, 2009.

Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency. GAO-09-161. Washington, D.C.: December 2, 2008.

Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed. GAO-08-200. Washington, D.C.: January 24, 2008.

Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments. GAO-08-78R. Washington, D.C.: October 16, 2007.

Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure. GAO-08-32. Washington, D.C.: October 12, 2007.

Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration. GAO-07-154. Washington, D.C.: March 15, 2007.

Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved. GAO-06-1021. Washington, D.C.: September 19, 2006.

Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers. GAO-06-929. Washington, D.C.: September 12, 2006.

Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure. GAO-05-61. Washington, D.C.: October 6, 2004.

Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending. GAO-04-280. Washington, D.C.: January 30, 2004.

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Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk. GAO/GGD-00-3. Washington, D.C.: October 29, 1999.

Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure. GAO/T-GGD-96-117. Washington, D.C.: May 2, 1996.

Financial Derivatives: Actions Needed to Protect the Financial System. GAO/GGD-94-133. Washington, D.C.: May 18, 1994.

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Testimony of
Professor Howell E. Jackson,
James S. Reid, Jr., Professor of Law
Harvard Law School

Before the Senate Committee on Homeland Security and Governmental Affairs

Hearing on The Financial Crisis and the Breakdown of Financial Governance
Senate Homeland Security and Governmental Affairs Committee Hearing Room
SD-342 Dirksen Senate Office Building

January 21, 2009

Chairman Lieberman and Ranking Member Collins, I am delighted to have this opportunity to speak before your committee this afternoon and to participate in what I hope will be the beginning of a long overdue process leading to the transformation and modernization of financial regulation in the United States.

Let me begin by commending the staff of the Government Accountability Office in presenting a thorough and lucent overview of the shortcomings of the country's current system of financial regulation.[1] As the GAO study explains, our extraordinarily decentralized and fragmented system of financial regulation is poorly suited to supervise the financial services industry of the 21st Century. Jurisdictional divisions and subdivisions based on traditional financial sectors and subsectors create regulatory gaps and piecemeal, inconsistent solutions to common problems.[2] The result is a redundant and wasteful system of supervisory oversight, particularly ill-equipped to police a financial services industry in which financial conglomerates dominate. With the rest of the developed world having moved towards more consolidated financial oversight in recent years, our costly and inefficient regulatory system is a drag on American competitiveness.[3] Within academic and policy circles, the weaknesses documented in the GAO report are both well understood and

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[1] Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (January 2009) (GAO-09-216).

[2] For an overview of problems associated with maintaining a fragmented regulatory system, see Howell E. Jackson, *Regulation of a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319 (1999) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=166651).

[3] See Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J.REGULATION 253 (2007) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=839250).

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widely accepted to be a major shortcoming of our regulatory system. The GAO Report does an admirable job in documenting the existence and significance of these weaknesses. In my testimony today, I wanted to share with the committee my views on less well appreciated implications of the deficiencies identified in the GAO report.[4]

1. Oversight of systemic risk has been incomplete and inconsistent, based on anachronistic jurisdictional divisions and leaving no single governmental body with a comprehensive and informed view of all areas in which the financial services industry poses material risks to market stability.

A striking lesson of the current financial crisis is that no single regulatory body has a comprehensive view of all the sources of systemic risk within our financial system.[5] As lender of last resort, the Federal Reserve has traditionally been responsible for overseeing systemic risks, but its regulatory powers were largely defined more than half a century ago when the banking system was considered to be the primary source of systemic financial risks. In the mid Twentieth Century, jurisdiction over bank holding companies and state-chartered member banks may have provided the Board sufficient jurisdiction to police systemic risks. But the sources of systemic risk has long since expanded beyond the banking sector. Major investment banks, large insurance companies, hedge funds and other participants in the burgeoning OTC derivatives markets, government sponsored enterprises like Fannie Mae and Freddie Mac, all have proven to be major sources of systemic risk beyond the scope of the Board's current supervisory mandate or in-house expertise.

While the precise manner in the Federal Reserve Board could and should be transformed into an effective monitor of market stability is a subject of debate,[6] the weaknesses of the current

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[4] My remarks draw from two recent papers comparing US financial regulation to the more consolidated systems of financial supervision found in other developed countries, see Howell E. Jackson, Learning from Eddy: A Meditation Upon Organizational Reform of Financial Supervision in Europe, Conference Volume (Michel Tison, ed.) (Cambridge University Press forthcoming 2009) (avail. at . http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325510), and proposing how the United States might approach the task of consolidation, see Howell E. Jackson, A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States (Nov. 12, 2008) (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1300431 (forthcoming *Harvard Journal of Legislation* 2009).

[5] In a report released last Spring, the Treasury Department identified the need for a broadly empowered market stability regulator. See United States Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 2008) (avail. online at http://www.treas.gov/press/releases/reports/Blueprint.pdf) [hereinafter Treasury Blueprint].

[6] For a recent overview of several options for integrating market stability oversight with other aspects of financial regulation, see Committee on Capital Markets Regulation Releases Recommendations for Reorganization U.S. Regulatory Structure (Jan. 14, 2009) (avail. at. http://www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf).

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regulatory system includes five major areas of market stability oversight where reform is needed. First, rather than having to depend on cramped jurisdictional provisions drafted decades ago, the Board should be given an open-ended mandate to monitor the entire financial services industry to identify and help rectify sources of systemic risk before the risks manifest themselves into real losses. Second, the scope of the Board's lender of last resort powers should be clarified and expanded so that the Board does not have to concern itself with operating at the boundaries of legal authority in times of crisis.[7] Third, the legal requirements for defraying the costs of systemic intervention should be made consistent throughout the financial service industry with at least a portion of those costs being imposed on the financial services industry itself both to promote responsible conduct and to limit the burden imposed on taxpayers and future generations.[8] Fourth, the Board needs to develop its expertise in financial areas, such as insurance companies and derivative markets, where it has traditionally lacked authority and deferred to the oversight of others. Fifth and finally, as the most effective and efficient responses to systemic risks consists of prudent regulatory interventions before problems arise, the Federal Reserve Board should be given clear authority to require other front-line regulators to take appropriate corrective actions when financial industry behavior threatens the stability of the broader economy.[9]

2. The manner in which Congress has designed the regulation of the financial services industry – devising legalistic divisions of authority and relying upon independent agencies to resolve inter-agency disputes – is ill-suited to a complex and dynamic financial services industry and contributed to the current financial crisis.

Another important weakness in our current regulatory structure is the manner in which Congress has chosen to allocate federal jurisdiction over the financial services industry. The oversight of home financing is a good example. The Department of Housing and Urban Development has authority over mortgage closing documents, but the Federal Reserve Board is charged with policing disclosure of mortgage interest rates and subprime loans.[10] No less than five separate agencies have authority over the safety and soundness of the mortgage loans that federally insured depository institutions make, including the propriety of mortgage underwriting standards.

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[7] See Sue Kirchhoff and Barbara Hagenbaugh, *In Fed We Trust, But Can It Get Us Out of this Mess? Bernanke's Team Takes Unheard-of Actions*, USA TODAY, Mar. 18, 2008.

[8] See Howell E. Jackson, *Building a Better Bailout*, CHRISTIAN SCIENCE MONITOR, Sept. 25, 2008.

[9] In many areas, systemic risks are best addressed before problems arise through higher capital requirements, more stringent investment restrictions, or better control over complex payment and clearing systems.

[10] The inability of the Department of Housing and Urban Development to respond effectively to mounting evidence of customer abuse in mortgage originations is documented in Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J. LAW, BUS. & FIN. 289 (2007).

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The SEC has been responsible for overseeing the disclosure documents and accounting treatment of the securitization process through which most American mortgages are financed, as well as over the credit rating agencies that have opined on the credit-worthiness of securitization transactions. In addition, the states have limited authority to establish fiduciary standards for mortgage brokers. On top of all of this, Congress this past year added a new federal entity to keep track of the licensing of mortgage brokers at the state level.[11] With this degree of fragmentation, it is no surprise that no one in the federal government foresaw the mortgage crisis coming and no one is being held accountable for the severe economic consequences that have resulted.

But fragmentation of responsibility is just part of the problem. In areas where federal agencies are given authority, the jurisdiction is often narrowly constrained and lacks the flexibility to allow agencies to intervene where they do see problems. The hedge fund industry is a good example. Earlier this decade, the Securities and Exchange Commission recognized the need to more carefully monitor the operations of hedge funds and proposed amendments to its regulation under the Investment Advisers Act to exert jurisdiction. Notwithstanding the strong policy arguments in favor of this reform, industry lawyers persuaded a divided panel of the District of Columbia Circuit that the initiative was beyond the Commission's statutory mandate and so the hedge fund industry was left largely beyond the SEC's supervisory control.[12] The federal reports abound with other examples of private parties challenging regulatory rulemaking, delaying reforms even when the courts reject the underlying claims.[13] Often, as was the case of the hedge fund litigation, the source of the problem was that the agency in question lacked broad a jurisdictional mandate and had to rely on narrowly defined jurisdictional authority devised decades ago for a much simpler financial system.

The problem of ill-defined jurisdictional boundaries is most acute where two or more agencies contest jurisdictional authority. The boundaries between banking, securities, and insurance are notoriously fuzzy, and industry participants are expert in playing one agency off against another, often choosing to operate under the oversight of the regulatory with the most lax regulatory requirements and sometimes exploiting jurisdictional uncertainty to operate in a twilight zone free from any effective oversight. Although the dangers of these jurisdictional gaps have been well understood for many years, Congress has failed to resolve the difficulties. The boundaries between SEC and CFTC oversight of the lines between securities and commodities is a notorious example of an instance in which Congress has failed to devise clear and sensible jurisdictional boundaries, with one consequence being that the credit default swap market was allowed to grow to gargantuan

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[11] The Secure and Fair Enforcement of Mortgage Licensing Act of 2008 was incorporated into the Housing and Economic Recovery Act of 2008, which President Bush signed into law on July 30, 2008.

[12] See Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006).

[13] See Jackson, *Regulation of a Multisectored Financial Services Industry*, *supra* note 2.

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size without any effective oversight.[14] But one could just as easily point to divisions between securities and insurance or insurance and banking as posing similar problems. And even where Congress has acted, the response has often been provisional and equivocal. For example, for a number of the key jurisdictional questions addressed in the Gramm-Leach-Bliley Act of 1999, Congress declined to given clear authority to any single agency, but rather instructed the courts to resolve jurisdictional disputes without deference to the expertise of any supervisor.[15] In other cases, when faced with hard questions, Congress left it to the relevant agencies to work things out amongst themselves, in one case prompting a contested rulemaking process that stretch out over a decade, required an additional act of Congress to keep things moving, and resulted in promulgation of a byzantine regulation, which few can understand and with which no one is fully satisfied.[16]

The underlying problem here is that many financial products are functionally similar and well-advised financial services firms are capable of exploiting the legalistic boundaries of jurisdictional authority that characterize our system of financial regulation. Without broad jurisdictional mandates, our financial regulators will remain at a serious disadvantage in setting policy for new financial products and risks. Our reliance on multiple financial supervisors only exacerbates the problem. Each agency, after all, has its own bureaucratic imperatives – and a phalanx of lobbyists eager to defend those imperatives[17] – and can be expected to defend its turf against competing sources of authority. By allowing these agencies to operate under independent mandates and by failing to specify an unambiguous hierarchy of authority, Congress has perpetuated a supervisory system prone to paralysis and incapable of keeping pace with the modern financial services industry.

3. The Fragmentation of Financial Regulatory Structure Impairs the Quality and Flexibility of Supervisory Oversight in the United States

In addition to problems of jurisdictional gaps and a lack of comprehensive oversight, our

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[14] See U.S. General Accounting Office, CFTC and SEC: Issues Related to the Shad-Johnson Jurisdictional Accord (April 2000) (GAO/GGD-00-09). See also Christopher Cox, *Swapping Secrecy for Transparency*, N.Y. TIMES, Oct. 18, 2008 (discussing need for SEC oversight of credit default swaps).

[15] See, e.g., Gramm-Leach-Bliley Act, Pub L No 106-102, 113 Stat 1409 (1999), codified at 15 USC § 6714(e) (2000) (providing that in a dispute between federal and state insurance regulators over the preemptive effect of a federal statute, the court shall decide the issue "without unequal deference").

[16] This case involved the authority of the Securities and Exchange Commission to exercise jurisdiction over bank securities activities. See Regulation R: Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, 72 Fed. Reg. 56,514 (Oct. 3, 2007) (codified at 12 C.F.R. § 218 and 17 C.F.R. §§ 240, 247).

[17] For a theoretical explanation of why lobbyists may sometimes oppose policy reforms that would actually advance their clients' interests, see Matthew C. Stephenson & Howell E. Jackson, Lobbyists as Imperfect Agents: Implications for Public Policy in a Pluralist System (Draft of Jan. 16, 2009).

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fragmented regulatory structure impairs the quality and flexibility of financial supervision in the United States.[18] Agencies with narrow mandates have more difficulty attracting and retaining high quality personnel. With their limited jurisdictional scope, fragmented agencies offer less attractive career opportunities for their personnel with fewer possibilities for promotion and professional development. Moreover, since political appointees provide the top level of leadership within each fragmented agency, there are less opportunities for high ranking positions – and greater turnover with each new Administration – than exist in more consolidated supervisory systems.

Our extreme decentralization of regulatory jurisdiction also complicates allocation of supervisory resources. The Federal Reserve System, for example, employs many of the country's most talented economists and conducts a wide range of top flight research. But its research efforts tend to focus on matters within the Board's jurisdiction, like bank mergers and capital requirements. So other areas of financial regulation – notably securities markets that fall within the jurisdiction of the SEC, which hire many more lawyers than economists – have not been carefully studied and it is now clear that key aspects of the securities markets, such as the liquidity risks of repurchase agreements and counter-party risks from OTC derivatives, were not well understood.[19] The current financial crisis offers further examples of structural impediments of our regulatory system. When in late summer of 2008 the Federal Housing Finance Agency was confronted with the impending failure of Fannie Mae and Freddie Mac, the agency had to resort to borrowing personnel from federal banking agencies to examine the GSE's financial postures, lacking sufficient expertise on its own staff.[20] Similarly, when Bear Stearns encountered difficulties earlier in the same year, the SEC had to call on the Federal Reserve Bank of New York in order to come up to speed with the investment bank's deteriorating condition, and eventually had to rely on the Federal Reserve Board's lending authority to forestall financial crisis.[21] Even though the United States maintained the world's largest and best funded regulatory system – both in absolute and relative terms[22] – we lacked adequate analytical depth in sector after sector as the current financial crisis unfolded. A related problem concerns differential access to resources. The funding arrangements for federal supervisory agencies differ markedly. Some, like the Federal Reserve Board and the PCAOB, have a high degree of autonomy in setting budgets and gaining resources. But other agencies are more dependent on the annual appropriation process, and often find their access to resources fluctuating

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[18] For a discussion of the advantages of consolidated supervision on these issues, see Jackson, *Learning from Eddy*, *supra* note 2.

[19] See Testimony of Erik Sirri, Director, SEC Division of Trading and Markets, Concerning Oversight of Risk Management at Investment Banks Before the Subcommittee on Securities, Insurance and Investment of the Senate Committee on Banking, Housing and Urban Affairs (June 18, 2008).

[20] See Statement of James B. Lockhart (Sept. 7, 2008) (avail. at http://www.ofheo.gov/newsroom.aspx?ID=456&q1=1&q2=4).

[21] See Stephan Labaton, *Testimony Offers Details of Bear Stearns Deal,* N.Y. TIMES, Apr. 4, 2008.

[22] See Jackson, *Variation in Regulation Intensity*, *supra* note 3.

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with their political fortunes, creating further inconsistencies in supervisory practices.

Not only does our siloed approach to financial regulation produce an uneven regulatory structure, it makes individual agencies more vulnerable to regulatory capture.[23] When the sole task of a regulatory agency is to oversee a single subsector of the financial services industry, the agency is much more likely to interpret its mission as ensuring the survival and growth of the subsector it oversees. So, for example, the Pension Benefit Guarantee Corporation, which has as its sole mission to guarantee private defined benefit pension plans, has a strong incentive to relax the funding rules for these pension plans, even if this relaxation exposes the government to increased risks and encourages private employers to slough off obligations on the federal government. Similarly, in an effort to attract more depository institutions to federal charters, the Comptroller of the Currency and the Office of Thrift Supervision engaged over the past decade in what many regarded as the cavalier preemption of state consumer protection laws in order to provide national banks and federal thrifts a competitive advantage over their competitors with state charters.[24] In my view, the narrow jurisdictional mandates of these regulatory agencies contributed to an excessive degree of preemption, weakening protections for consumers and facilitating an explosion of ill-advised mortgage originations and excessive growth in consumer credit.

4. Our fragmented regulatory system also undermines the ability of regulators to protect consumers from financial fraud and to promote effective and comprehensive approaches to improving financial literacy.

A separate weakness of our fragmented regulatory system is the absence of a central locus for consumer protection and financial education. While many agencies have offices charged with some aspect of consumer protection, the overall result is a diffuse effort and one that often takes a back seat to prudential oversight and other matters.[25] Even the otherwise estimable Federal Reserve Board performed poorly with its consumer protection responsibilities over the past decade as its Division of Consumer and Community Affairs failed to appreciate the mounting risks of subprime credit and shied away from imposing meaningful constraints on non-prime credit until the housing crisis was well underway.[26] As mentioned earlier, the consumer protection efforts of the Comptroller of the Currency and the Office of Thrift Supervision were wholly inadequate, as were

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[23] See Jackson, *Learning from Eddy*, *supra* note 4.

[24] See Howell E. Jackson & Stacy A. Anderson, *Can States Tax National Banks to Educate Consumers About Predatory Lending Practices?*, 30 HARV.J.LAW &PUB.POL'Y 831 (2007) (avail. at http://www.law.harvard.edu/students/orgs/jlpp/Vol30_No3_Jacksononline.pdf).

[25] See Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation*, *supra* note 4 (discussing importance of establishing clear mandate for consumer protection functions and not allowing them to become peripheral concerns for organizations focusing on other tasks).

[26] The Board ultimately adopted more stringent rules this past summer. See Final Rules Amending Home Mortgage Provisions of Regulation Z, 73 Fed. Reg. 44,523 (July 14, 2008).

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those of the Department of Housing and Urban Development, which coddled mortgage brokers for years despite ample evidence that large segments of the mortgage broker industry were abusing the trust of their clients and promoting unsafe and unsustainable borrowing.[27]

But even if our regulatory agencies had genuinely wanted to promote consumer protection in recent years, the fragmented structure of our regulatory apparatus would have made that task difficult and costly. Effective consumer protection requires consistent regulation and comparable oversight for functionally similar products. With our divided regulatory structure, that consistency and comparability would be difficult to achieve. Money market mutual funds, regulated by the SEC, are functionally similar to bank deposits.[28] Equity index annuities, regulated by state insurance agencies, are substitutes for many securities products sold through SEC-registered broker-dealers.[29] In our current regulatory system, no government body has the ability to ensure that these functionally similar products are regulated and marketed in the same way. And regulatory agencies have little ability or inclination to coordinate amongst themselves to increase comparability and consistency. As a result, consumers do not get comparable disclosures about similar products and cannot be assured consistent legal protections for similar products across the financial services industry.

A further drawback of our federal regulatory system is its inability to promote financial literacy in a sensible manner.[30] While all financial regulatory agencies acknowledge the importance of financial literacy and many undertake some amount of financial education, the resulting patchwork of initiatives is inherently inadequate and ineffectual. The foundations of financial literacy include a basic understanding of compound interest, the relationship between risk and return, appropriate and inappropriate uses of credit, how to make a realistic life-time savings plan, the importance of comparing prices and services, and an appreciation of the conflicts that may compromise the recommendation of financial advisers. A sensible program of consumer education starts with these basics, and not the details of credit card terms or the closing terms of a home mortgage. Around the world, consolidated financial supervisors are gaining experience with national programs of financial education and the development of financial literacy teaching modules

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[27] See Jackson & Burlingame, *Kickbacks or Compensation*, *supra* note 10.

[28] The Treasury Department's emergency efforts to devise an ad hoc federal guarantee program for money market mutual funds, akin to longstanding FDIC insurance for banks, arises out of an inconsistency in federal guarantees for functionally similar products. See Treasury Announces Guarantee Program for Money Market Funds (Sept. 19, 2008) (avail. at http://www.ustreas.gov/press/releases/archives/200809.html).

[29] For a recent SEC proposal attempting to restate the division between securities and insurance, see Proposed Rule on Indexed Annuities and Certain Other Insurance Contracts, 73 Fed. Reg. 37,752 (July 1, 2008).

[30] For a collection of excellent writings on the importance of financial literacy, I recommend the work of Professor Annamaria Lusardi of Dartmouth College and the NBER. See http://www.dartmouth.edu/~alusardi/.

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for use in primary and secondary schools.[31] In the United States, no such efforts are in evidence because no single government entity has the responsibility for promoting financial literacy.

5. Our fragmented regulatory system oversees an increasingly globalized financial services industry but is ill-equipped to coordinate with regulatory authorities in other jurisdictions and with the many multilateral organizations that coordinate regulatory affairs around the world.

A final and often overlooked weakness of our regulatory system is the difficulty it creates for coordinating with regulatory officials and organizations outside the United States. The absence of any federal authority responsible for overseeing American insurance companies is one obvious example of this deficiency,[32] but problems in international coordination exist for other sectors of the financial services industry as well. The divided authority over securities and futures in the United States – an allocation of supervision not found in any other major economy – is one example[33] but so too is the division of federal authority over depository institutions, a complexity that compromised the ability of the United States to participate effectively in the multi-lateral negotiations leading up to the Basel II capital reforms, as federal banking regulators routinely took conflicting positions with respect to negotiations, often squabbling in public setting and delaying and complicating the negotiation process. In major foreign capitals – where financial supervision in most countries has been consolidated into one or two overarching agencies – it is a commonly noted source of frustration that the United States cannot speak with one voice and that interactions with U.S. authorities are notoriously difficult and time-consuming to coordinate.

Aside from complicating international negotiations, the fragmentation of regulatory authority in the United States adds real costs and diminishes supervisory efficacy. All of the major supervisory units maintain their own international divisions, each of which must liaise with foreign counter-parts, negotiate memoranda of understandings to coordinate enforcement actions, and develop protocols for overseeing foreign firms and cross-border transactions.[34] All of the regulatory gaps and jurisdictional ambiguities that plague domestic oversight are replicated in the international

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[31] The Bristish consolidated regulatory agency, the Financial Services Authority, has done particularly innovative work with comprehensive financial education initiatives. See, e.g., http://www.moneymadeclear.fsa.gov.uk/.

[32] See Treasury Blueprint, *supra* note 5.

[33] For a discussion of how this divided authority has led to inconsistent treatments of foreign securities and futures exchanges, see Howell E. Jackson, Mark Gurevich, & Andreas M, Fleckner, *The Controversy Over the Placement of Remote Trading Screens from Foreign Exchanges in the United States,* 1 CAPITAL M ARKETS L AW J OURNAL 54 (2006). (avail. at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=921435).

[34] See Howell E. Jackson, *Toward a New Regulatory Paradigm for the Trans-Atlantic Financial Market and Beyond: Legal and Economic Perspectives*, __ EUROPEAN BUS. ORG. L REV. ___ (forthcoming 2009).

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context, but the consequences can be even more severe. Especially where the U.S. imposes more stringent regulatory requirements, regulatory officials need to be in constant dialog with foreign authorities, otherwise transactions will simply move off-shore to escape US oversight. Moreover, the United States must speak with one consistent regulatory voice if it hopes to lead the world's economies in devising appropriately harmonized and efficiently integrated system of global financial oversight. Without effective and efficient international cooperation, US financial regulatory authorities are handicapped in preventing regulatory arbitrage across international boundaries and in maintaining the integrity of our financial markets.[35]

* * * * *

We are today in the midst of a severe financial crisis that tests the wisdom of our political leaders, the ingenuity of our businesses, and the patience and endurance of the American people. For the most part, our country's task is to regain economic ground lost and personal wealth dissipated over the past few years. But with respect to financial regulation, the current crisis offers a unique opportunity to correct the errors of the past and devise a new system of financial regulation that will sustain the American economy and safeguard the wealth of the nation in the years ahead. This is a rare and precious chance. I would urge the members of this Committee and your colleagues in Congress to seize the moment.

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[35] One positive aspect of a dynamic global market is that other countries can now provide laboratories for regulatory innovation, as they have in the area of consolidated supervision. See Jackson,. *Learning from Eddy*, *supra* note 4. Whereas the dual banking system and the division of federal regulatory authority once may have been useful in providing this dynamism within the United States, the global financial market is now a better source of regulatory competition.

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Filling Gaps and Dark Holes: Restructuring the Financial Regulatory Apparatus for the Next Crisis

Written Testimony of Steven M. Davidoff*
Prepared for the U.S. Senate
Committee on Homeland Security and Governmental Affairs
January 21, 2009
"Where Were the Watchdogs? The Financial Crisis and the Breakdown of the Financial Governance"

Introduction

Chairman Lieberman, Ranking Minority Collins, and other members of the Senate Committee, I would like to start by thanking you for giving me an opportunity to testify at this hearing to review and assess the adequacy of the current structure of the U.S. financial regulatory system.

Before turning to the substance of my testimony, I would like to summarize the important themes:

1. *The Current System is Fractured and Archaic.* The current financial regulatory structure is a quilt work of nine primary regulators with sometimes differing and overlapping responsibilities.[i] It is not structurally capable of regulating today's complex, interconnected financial markets. The current regulators should be consolidated into three regulators: a financial markets regulator, bank capital regulator and systemic risk regulator. To the extent full financial integration is not politically achievable, Congress should create regulatory champions in each of these three areas who can dominate the remaining other regulators and grow and absorb them or their responsibilities over time. The recommendations in this testimony are goals to be fulfilled over time and phased implementation may be the most politically feasible route.

2. *Private Markets Should be Subject to Increased Oversight.* The private and quasi-private markets now overshadow the public equity markets in size and scope. For example as of June 2008, the private over-the-counter derivatives market had a notional value of $683 trillion.[ii] Meanwhile, hedge funds, private equity funds, endowment funds and other capital pools exist and invest largely free from the oversight of any financial markets regulator. It is estimated that hedge funds alone have approximately $1.5 trillion in assets under management, a figure that was a higher $1.9 trillion in the prior year.[iii] Given the role of the "private markets" in the financial crisis and their significant size, any future financial regulator should have oversight authority over the trading and issuance of securities, including derivatives and credit default swaps (*CDSs*), throughout the entire financial market, both public and private.

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3. *Filling Regulatory Gaps and Black Holes*. Any systematic regulatory reform must encompass the entirety of the financial system. It cannot leave gaps, black holes (i.e., deliberately unregulated areas) or financial institutions without potential oversight. Otherwise regulatory arbitrage will be possible. In particular, any systemic risk regulator should have potential oversight over the entire financial market and all financial institutions, including insurance companies, should be subject to financial regulatory oversight. Exact capital requirements imposed on financial institutions, if any, should be decided through the regulatory process undergirded by cost-benefit analysis with regard to the systemic risk and with reference to the Basel II standards as they may be reformed. The possibility should remain, particularly in the case of insurance and banking, for continued, delegated supervision through state regulators subject to appropriate monitoring.

4. *Regulating Forward Not Backward*. In each crisis there is a tendency to regulate to the past problem and not the future. But the mistakes of the past are unlikely to be repeated soon; in the next crisis the unknown mistakes of the future will again stress-test the system. Moreover, the financial revolution continues to allow for more sophisticated and different financial products. Any regulation must bestow regulators ample authority to adjust their regulation, and respond to modern developments and the ability for regulatory arbitrage. Congress should focus on building "flexible regulators" which have the institutional capacity and jurisdictional scope to respond to future crises and developments.

5. *Regulating Politically and Feasibly*. In building "flexible regulators" Congress should focus on building a sustainable financial architecture but should leave the details of specific rules to be filled in by the selected regulator. Otherwise, Congress risks erecting rules that are either not adaptable to future changes or are not fully informed by later research on the financial crisis and our capital markets. Moreover, by focusing on setting up an apparatus rather than writing entire regulatory codes, Congress will forego getting stuck in the mundane details and missing the opportunity the financial crisis presents for regulatory reform. Of course, in particularly important areas Congress may still choose to mandate a particular outcome.

6. *Relevancy of the Current Crisis*. The root cause of the current crisis appears to have been inordinately low interest rates which created a credit and liquidity bubble and led to undue leverage and risk-taking by both individuals and financial institutions who believed that "housing prices never go down". The collapse of this bubble has exposed many failings of the U.S. regulatory architecture. Regulation should address these failings but realize that the panic of Fall 2008 was based on a series of events itself based on a misheld belief and economic policy. Accordingly, regulators provided expanded jurisdiction should be careful to regulate in a way that accounts for the extreme stress placed upon the system by that collapsed bubble and fixes the faults exposed but does not over-compensate.

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7. *Setting the right balance*. In regulating, Congress must remember that the prior system, despite all of its faults, led to the United States becoming the capital center of the world. Any future regulation must allow for the continued development and preeminence of the U.S. financial system in a globalized world. Here, I must emphasize that when I speak of providing "oversight" responsibility, it does not necessarily equate with heightened substantive regulation, but the potential for regulation if a regulator exercising its prudent authority deems it appropriate. In particular, Congress should require cost-benefit analysis for any rule-making by these agencies.

My recommendations generally gibe with the specific framework put forth in the GAO report that any future regulation should have "clearly defined regulatory goals", be "appropriately comprehensive", be "flexible and adaptive" and have a "system-wide focus". [iv] However, I offer a substantive recommendation for implementation of the GAO's framework. I also disagree with the GAO's deliberate failure to put as a primary goal of financial regulation the formation of capital and promoting economic growth. This is the purpose of the financial markets and as such should be facilitated by any regulation. Finally, I note that the many comment letters on the GAO report reveal the wide array of political interests and beliefs at issue in this debate. Some of these interests would prefer the status quo, fractured regulatory system. I address below why that is increasingly unpalatable and not in the nation's best interest.

I would also like to add a caveat to my discussion. This is not a formal academic research paper, but rather is written for a widespread audience of policymakers, regulators and the public generally. Accordingly, while I make policy recommendations and draw conclusions informed by the academic and wider research literature, my own conclusions are simply that – recommendations based on the information currently available and not original research.

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The Root Causes of the Financial Crisis

The causes of the current financial crisis are still the subject of much study and debate and will remain so long after Congress acts on any financial reform. Nonetheless, at this point eighteen months into the crisis we have a rough sketch.

In summary, historically low interest rates led to excessive borrowing by both individuals and financial institutions. With respect to individuals, a primary focus of borrowing was with respect to real estate, a readily accessible investing asset for most people. The consequence was the rapid rise of housing prices. These prices were increased by demand from so-called "sub-prime" borrowers. During the period from 2005-2006, subprime lending was approximately $1.2 trillion of which $960 billion was securitized.[v] The amount of outstanding subprime mortgage debt grew 801% from 2000 through 2006 to $732 trillion.[vi] These loans were often issued and underwritten under the assumption that "housing prices do not fall".

But when the housing and credit bubble did indeed begin to deflate due to the subsequent rise of interest rates, and housing prices halted their growth and began to fall ever more rapidly, the subprime market, the most vulnerable market, was the first to collapse. Many of these loans entered into default and foreclosure rates began to increase. The high foreclosure rate has had a domino effect across the real estate market pushing prices further lower.

It is now clear that in many instances borrowers were placed into loans they can not now afford. Theoretically, the lender/lendee relationship could have served as a circuit-breaker creating a monitoring function that prevented these inappropriate loans instead focusing on the ability of borrowers to repay. However, the traditional "It's a Wonderful Life" banking model where lenders and borrowers passed each other on the street and lenders personally assessed the creditworthiness of their clients has long past. Mortgages are now securitized into asset-backed facilities called collateralized debt obligations, or CDOs, and sold into the market as mortgage-backed securities or MBSs. Subprime residential mortgages are typically securitized in specialized CDOs called residential MBSs, or RMBSs.[vii] Lenders now serve as intermediaries in this "originate to distribute" model and are more concerned with the ability to sell these loans than for the loans to be repaid.[viii] Many of these lenders, particularly for subprime mortgages, were non-bank lenders subject to differing oversight and regulation than their bank counter-parts.

RMBSs are often voluntarily registered with the SEC in order to offer them to a wider array of investors while other types of CDOs generally are not.[ix] The SEC liberalized the registration process for these securities in 2005 by introducing Form A/B.[x] The form allowed for streamlined disclosure and discarded the obligation of underwriters to perform due diligence on CDOs to confirm adequate loan documentation.[xi] In essence, for those CDOS that were registered, the SEC relied upon private underwriters to uphold standards. Here, the underwriter also procured a private ratings agency to rate the CDO's tranches. Notably though, the SEC was

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only responsible for ex ante regulating disclosure in the securitization process when the underwriter chose to register the securities and offer them generally to the public. In other cases the SEC's oversight was limited to its antifraud powers. And in no instances was the SEC responsible for the mortgage origination process. In addition, under the Credit Rating Agency Reform Act, the SEC was affirmatively denied the ability to "regulate the substance of credit ratings or the procedures and methodologies by which any [rating agency] determines credit ratings."[xii] In hindsight, the SEC and the other financial regulatory agencies lacked complete oversight over this market; and it was a market that was at best subject to overlapping and conflicting oversight.

It now appears that in the housing boom, the underwriting standards for MBSs generally and RMBSs in particular decreased as the housing boom progressed.[xiii] Moreover, in some instances outright misdirection and fraud directed at consumers by mortgage brokers has been reported.[xiv] And, of course, the ratings agencies were horribly off the mark in assessing the risks of these securities.[xv] The role of individual actors and regulatory agencies in the mortgage crisis is still being fleshed out. Nonetheless, it appears that the direction of fault appears clearer -- it has already been found that the higher the rate of subprime mortgage securitization the higher the rate of default by a measure of approximately 20%.[xvi] The securitization process appears to be at the heart of the mortgage crisis due to the moral hazard and excess risk taking it engendered.

The general decline in the subprime market seeped into the general market in approximately August of 2007. At that time, there was not only a flight from securities containing subprime mortgages and RMBSs, but also a general flight from MBSs due to disbelief about the accuracy of their ratings and the quality of information in the market.[xvii] The result was a crash in pricing in these assets and a flight away from their ownership. At that time, the general credit markets began to freeze and the "merry-go-round" literally stopped. Financial institutions were hit with a triple whammy 1) declining real estate assets and securities on their balance sheet which they could not dispose of and now were priced at distress levels, 2) inordinate leverage from the credit bubble, and 3) a declining economy which reduced their general profitability. Financial institutions who had dealt heavily in real estate-related securities or markets were particularly vulnerable. In addition, many financial institutions had engaged during this time in widespread use of off-balance sheet special purpose vehicles to remove liabilities from their balance sheet. In July 2008 Citigroup alone had $1.1 trillion in off balance sheet special purpose entities.[xviii] In the wake of the financial crisis many of these liabilities were forced by the banks to be assumed placing further stress on their capital adequacy.

During the period from August 2007 through March, 2008, banks rushed to recapitalize from private investors. Nonetheless, the week of March 11, 2008 Bear Stearns collapsed. In hindsight, the investment banking model was one over-susceptible to shocks. Unlike bank holding companies, investment banks historically had a leverage model ranging from 20:1 to 30:1 and as of August 2007, three of the five investment banks, including Bear, had a leverage

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ratio greater than 30:1.[xix] Meanwhile, for day-to-day capital liquidity investment banks relied on repurchase agreements and prime brokerage reserves. The source for this capital was other investment banks and hedge funds. Either party could rapidly move these reserves in the case of doubt as to the financial institution's viability. In a panic the model would quickly collapse, and that week of March 11 a classic run on the bank occurred with Bear Stearns. Fear and information asymmetry over Bear's viability led to a self-fulfilling loop as Bear's stock price declined and counter-parties moved to withdraw funds in response further hastening Bear's downfall. We all know what happened to Bear, but going into March Bear was rated AAA on some of its secured debt by the ratings agencies and the SEC had felt Bear to be "comfortably" capitalized.[xx]

The fall of Lehman Brothers similarly unfolded and was also due in part to over-reliance on highly movable capital for daily liquidity. However, Lehman's downfall showed the interconnectedness of the financial system. The fall of Lehman led the money market fund Reserve Primary to "break the buck". Reserve Primary broke the dollar floor after writing off $785 million in Lehman Brothers debt. The resulting outflow of money was remarkable; Reserve Primary's assets plunged more than 60 percent to $23 billion in two days.[xxi] Over that week, $170 billion of investor funds flowed out of the money market institutions as investors began to realize that these funds lacked a federal guarantee like ordinary bank deposits.[xxii] The Federal Reserve was forced to step in with a program to insure money market funds. The reason the Federal Reserve did so was due to the role money market funds play as purchasers in the commercial paper market, the primary source of working capital for much of corporate America.[xxiii] If the money market fund industry ceased to function, the commercial paper market would collapse leaving companies who relied upon this financing no choice but to file for bankruptcy. Meanwhile, the fall of Lehman led to a failure of confidence in the investment banking model. This led to Merrill Lynch's acquisitions and the conversion of Morgan Stanley and Goldman Sachs to bank holding companies as they sought more stable forces of funding capital liquidity. Investors lacking information on the pricing of any assets ran for safe assets such as U.S. Treasuries.

At the time, there was a significant outcry that the failing of Lehman and perhaps Bear Stearns was due to shorting of their stock in the market and the crisis in confidence it created. In some cases it has led to cries of regulation of the CDS market and a prohibition on shorting. CDSs notably, were deliberately legislated to be left unregulated by Congress in The Commodity Futures Modernization Act of 2000. The veracity of these claims is unknown at this point. In fact, due to the lack of information about trading in the CDS and private market, I doubt anyone will ever be able to definitively conclude one way or the other whether this was a contributory cause of Bear or Lehman's collapse.[xxiv]

The full role of derivatives generally in the financial crisis still appears uncertain. Clearly in some circumstances derivatives increased risk heightening the impact of the rapid decline of MBSs (to be fair in some cases they served their function and did the opposite hedging risk). The

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opaque pricing of CDSs may have also led CDSs to be priced too low lulling the market into false security about the state of the housing market. More certainly, AIG was brought down because of underwriting of CDSs out of a London-based subsidiary. [xxv] AIG notably was regulated by the Office of Thrift Supervision as a savings and loan holding company because of AIG's control of a thrift, but AIG was not subject under this regulation to the same scrutiny or requirements of a bank holding company. Furthermore, the interconnectedness of the derivative world led to a great shock when Lehman collapsed and its massive derivatives trades had to be unwound. Nonetheless, as in the particular causes of Lehman's and Bear's downfall, we will likely never know the true impact of derivatives in the financial crisis as again the private derivatives market, particularly the CDS market, is not fully reported.

The Inspector General of the SEC issued on September 25, 2008 a report on the SEC's now defunct voluntary regulation program of the five investment banks, the Consolidated Supervised Entity program. Deprived of regulatory jurisdiction over these key market participants, the SEC readily agreed to a voluntary regulation program when the investment banks proposed it in 2002. The banks did not do so out of saintliness. Rather, they needed a primary regulator under the European Union Financial Conglomerates Directive, and preferred to accede to SEC regulation rather than be regulated directly by the European Union.[xxvi]

The program was doomed to fail and understaffed from the start –three SEC employees were assigned to monitor each bank.[xxvii] Moreover, the investment banks may have complied with their capital requirements and the CSE program generally, but the SEC never conducted appropriate, in depth inspections as to risk measurement, capital liquidity sources and other disclosure.[xxviii] This was true even after Bear fell. The investment banks were able to leverage a regulatory gap to avoid in-depth scrutiny of their leveraging and risk processes.

Initially deprived of statutory ability to fully address the crisis, the government would engage in what Professor David Zaring and I call "regulation by deal" in order to attempt to salvage the financial system. In a series of transactions, the government nationalized Fannie Mae and Freddie Mac, bailed out AIG, and arranged for the sale of Wachovia and the banking deposits of Washington Mutual. Then with the passage of the Emergency Economic Stabilization Act and adoption of the TARP program the Treasury Department agreed to invest $125 billion in the country's nine largest financial institutions. Since that time the government has been administering the TARP program; along the way the bail-out of AIG has been reworked, Citi has received a second set of TARP funds and GM and Chrysler received TARP funds under the automotive component of TARP.[xxix] As I write this, it is being reported that Citi and Bank of America are negotiating yet another round of TARP injections.

Each of these deals has been on different terms and structured seemingly on an ad hoc basis. From news report in the Wall Street Journal and other sources it appears that the coordination of the FDIC, Treasury and Federal Reserve on these individual bail-outs was sometimes strained by disagreement over each of their agencies' role and statutory capacity.

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This may have contributed to the ad hoc nature of the government's response.[xxx] The statutory limitations on these agencies, and the lack of an in-place lender of last resort, also affected the regulators' ability to fully respond to the financial crisis. I do not make an assessment of the government's response to the financial panic, but note that the perceived cure to a panic and general credit freeze is to restore confidence in the markets by assuring participants that there is no longer an informational deficit or otherwise by providing a strong, believable market back-stop.[xxxi]

Regulators and the Financial Crisis

When surveying the regulatory failures of the past years, it is easy to write off the event as due to a cascading panic brought on by the common misperception that housing prices never fall. And indeed some of the regulatory stress and panic was brought on by extreme events attributable to this now quaint misconception. However, viewing even the brief, preliminary and partial summary of the financial crisis above it is possible to see the regulatory black holes and gaps, as well as regulatory overlaps, that were a factor in the financial crisis. These included a lack of:

- an effective regulatory authority over the five investment banks, major pillars of our financial markets;
- regulatory authority over the CDS market, a $57 trillion notional value market;[xxxii]
- sufficient regulatory authority over the securities trading and issuing arms of insurance companies;
- sufficient regulatory authority over the ratings agency process;
- a coordinated systemic regulator in times of market panic who can statutorily function as a lender of last resort;
- a singular regulator with direct oversight over the "originate to distribute" mortgage model;
- any regulatory information gathering ability on the trading activities of hedge funds and other market participants outside of the public markets, particularly with respect to CDSs;
- accurate public understanding of the true financial state of financial institutions due to the continued use of off-balance sheet special purpose vehicles;
- an active, comprehensive financial consumer protection regulator to monitor proper disclosure for financial markets, particularly the consumer mortgage and credit markets; and
- coordination between the SEC, Treasury, FDIC, CFTC and Federal Reserve and other regulators over systemic market regulation.

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In some cases -- such as trading in CDSs -- these were information deficits which may have informed regulator response. In other cases -- such as the lack of a statutorily empowered systemic regulator -- these directly hampered the government's ability to respond to the financial crisis or perhaps do something earlier. But in large part these deficits arose from the fractured nature of our regulatory system. Here, the arbitrage potential of this system was self-apparent. For example, the five investment banks avoided stricter capital regulation and oversight by avoiding the strictures of the bank holding company act while credit default swaps were able to exist in a financial netherworld avoiding regulation as either a derivative or insurance when their promoters convinced regulators of both products to treat it is the other. [xxxiii]

The Future Financial Regulatory Structure

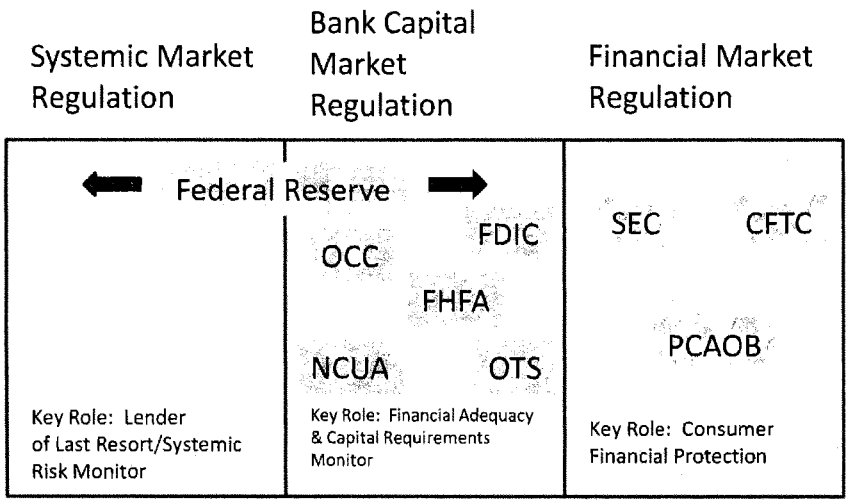
Regulation should not just address the prior crisis, but look forward. We should use the opportunity created by this financial crisis to fix the mistakes of the preceding years but also to regulate to future problems. Here, the most glaring hole in U.S. regulation remains its fractured nature. The GAO report ably details the history and archaic state of today's financial regulatory apparatus. Without knowledge of where the next crisis may come, any financial regulator should have jurisdiction over the entire financial market (both public and private) and over all financial institutions. For these purposes I define financial markets as the sale, purchase and trading of securities. Securities encompasses the trading of all types of derivatives, including insurance type derivatives such as credit default swaps. Regulators should have the ability to create markets for these securities and to require trading reports. Moreover, financial institutions should be broadly defined to include all financial institutions. This includes insurance, hedge funds, private equity, endowment funds, pension funds, and any other actor in our financial market that regularly trades, issue or underwrites securities or insurance.

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Much will be said about who should do what in this scheme. Some will favor a single-model regulator like England's FSA, others Australia's and The Netherlands' Twin Peaks model.[xxxiv] But, analytically one should separate out each of these functions into three broad categories:



CFTC=Commodities Futures Trading Commission; FDIC=Federal Deposit Insurance Corporation; FHFA=Federal Housing Finance Agency; Federal Reserve=Federal Reserve System; NCUA=National Credit Union Administration; OCC=Office of the Comptroller of the Currency; OTS=Office of Thrift Supervision; PCAOB=Public Company Accounting Oversight Board; and SEC=Securities and Exchange Commission.

It is self-obvious that the three functions here are overlapped in the current regulatory scheme. The regulatory functions of each of these agencies can be consolidated into one of three overlapping lines. Ideally, Congress would slot each of these into the right regulatory slot creating three regulators. But to the extent it is not politically possible or otherwise feasible, Congress should build regulatory champions. These should be dominant regulators in each field. Any other regulators in each of these fields should be put in a reporting position to the dominant regulator and their powers limited as much as possible. Additionally, the recommendations in this testimony are goals to be fulfilled over time and phased implementation may be the most politically feasible route.[xxxv]

The financial markets regulator would be the heir to the SEC, CFTC and PCAOB. The financial markets regulator should have the capacity to regulate the financial markets and financial institutions from a consumer protection aspect. The financial market supervisor should

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be given a charge for all financial market consumer protection. This means not only enforcement but education and responsibility for ensuring clear market disclosure. Today there is fractured responsibility for this, and for example, The Truth in Lending Act of 1968 is administered by the Federal Reserve. Regulation of this nature should be concentrated into a financial market regulator who is provided a strong mandate for consumer protection.

The systemic regulator would be a new regulator with power to be a lender of last resort. A systemic regulator should be set up to coordinate between the bank regulator and the financial markets regulator. This is likely the Federal Reserve, the natural choice to have new lender of last resort powers. These powers must be sufficiently broad to act, but also to have some discretionary element, so that the timing of their use is unknown to the markets. This would prevent the moral hazard that comes with certain knowledge of government intervention.

A third regulator should be set up for banking and leverage as heir to the FDIC, FHFA, NCUA, OCC, and OTS. This function could conceivably be within the systemic regulator building a twin peaks model. However, given the special governance arrangements of the Federal Reserve which keep it removed from Congressional oversight and influence in greater measure than a normal independent government agency, I believe this function would be better sited as an independent agency. Here, any institution which takes on leverage and has systemic ramifications should come within the oversight of the panel. In particular, both hedge funds and insurers should come under the aegis of the banking and capital regulator.

In essence this proposal is similar to the recommendations of most other regulatory restructuring plans but is different in calling for a broader possible reach of these regulators to cover the private markets and previously unregulated financial institutions like insurance companies.[xxxvi] Obviously, the powers of these regulators will overlap with state functions particularly in the insurance realm. But the proposal should preserve state regulation and overlay federal to allow for systemic oversight. In particular and again with respect to insurance it may be politically prudent to begin by simply offering a federal charter option for insurance companies and providing special regulation for non-State supervised affiliates of insurance companies who underwrite or trade securities.

Moreover, Congress should at this point focus on setting up sustainable and flexible regulatory structures. The Treasury Blueprint made a case for principles over rules-based regulation.[xxxvii] Congress should leave these issues up to the newly formed agencies; instead setting up broad frameworks and guidelines which allow for cost-benefit analysis and rule-making to fill in the broad financial architecture created. Where appropriate these agencies can return for further authorizing legislation.

This flexibility must take into account the future financial revolution. For example, the phenomenon of securitization of mortgage-based securities is thirty years old. Hedge funds have

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only reached prominence in the past decade. The capital markets will change and evolve. Regulation must allow for this creative destruction, being flexible not to stifle it but also to regulate it as necessary. The beauty of the Securities Act of 1933 and the Securities Exchange Act of 1934 is that they provided a framework which could be filled in by the regulator. The validity of this approach is witnessed by the continuing operation of these statutes. Congress should follow this pattern erecting a flexible financial apparatus and leaving the rule-writing largely to those agencies. If Congress writes set rules now these will need to be amended in the short future as financial markets change and new products develop. Moreover, Congress risks being unable to accomplish any reform if it gets bogged down in the details of each financial measure.

The assignment of broad categories of oversight function also allows for something that the current system does not: responsibility. The fractured and overlapping jurisdictions of the current regime allows for regulatory lapses to be passed to other agencies or otherwise for no fault to be attributed. A clearly defined role allows for agencies to assume this responsibility and build public confidence while at the same time having a real threat of being viewed as failing when they are so responsible.

Otherwise, the non-political arguments for preserving separate regulators in each of these categories are few. The most prominent is that separate regulators preserve regulatory competition thereby preventing uneconomic regulatory action. This argument was made in certain of the comment letters on the GAO report. For example, the existence of the CFTC provides a counter-part to the SEC by providing competition for regulatory jurisdiction and an alternative model of securities regulation.[xxxviii] Alternatively, in the banking context the American Bankers Association wrote in response to the GAO report that the current system "provides a useful check against any one regulator neglecting its duties, becoming too calcified for an ever-changing marketplace, growing overly bureaucratic and ineffective, or otherwise imposing regulatory conditions inconsistent with the ability of financial firms to serve their customers."[xxxix]

In today's globalized world, though, there are ample models abroad in other jurisdictions. Moreover, the global capital marketplace provides a significant competitor which provides an equivalent regulatory check.[xl] A further check is provided by interest groups and the active and open nature of today's government. In any event, at this point the costs of separate regulators in terms of conflict, lack of jurisdiction and diminished responsibility appear to outweigh any benefits. In particular, the size and scope of the financial market makes it inappropriate to be regulated by types or products –so-called functional regulation established by the Gramm-Leach Bliley Act of 1999 -- but rather the market should be regulated on a holistic basis. As the GAO report notes today's capital markets are too large and interconnected to allow for fractured or functional regulatory oversight. Congress should consolidate the current nine existing regulators into two or three strong, flexible regulators.

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Capacity for Regulation Does Not Equal Regulation

I want to be very clear here that I am not calling in this hearing for any specific measure of regulation. Rather Congress should empower each of these regulators with the capacity to regulate and have them determine the appropriate level of regulation. This would only be done if, after public debate and the rule-making process, the agency determines that costs of such regulation outweigh its benefits. [xli] As I have said, the beauty of the Exchange Act and Securities Act were that they allowed for similar flexibility. Congress would do well to mirror their successful aspects.

So, for example, a financial market regulator should have newfound oversight powers over all financial institutions, including hedge funds. In this testimony, I do not express an opinion as to whether hedge funds should actually be regulated, but instead that any regulator should be empowered to look at the issue and provided with the ability to impose regulation as part of its general power over all financial institutions. Similarly, a financial regulator should have the power to regulate CDSs requiring that they be traded on a central market or that unhedged positions held in companies must be reported. Again, the actual regulation would come, if at all, from the regulator through the rule-making process. Of course, in certain important areas Congress may want to impose its own rule. However, this should be only in important circumstances and should not devolve into a complete rule-making legislative process.

Furthermore, a bank capital regulator would likely have the powers to regulate capital requirements for not just banks, but all other financial institutions. This would break new ground for imposing capital requirements on hedge funds, for example. But while the bank regulator should have the power to impose such requirements, it may deem such requirements unnecessary or otherwise fulfilled by the market function and regulation of banks themselves. Finally, any systemic regulator will lack overall power if it does not have the power to regulate those financial institutions which can place material systemic risk on the capital market. In particular, again hedge funds should be subject to these rules as well as insurance operations.

Conclusion

We live in troubled times. But the financial crisis presents an opportunity to rework the modern financial architecture. Congress should take this unique chance to create a flexible regulatory apparatus which can respond to the unknown perils and change of the future. In particular, Congress should realize that the financial crisis of the past two years has exposed the fractured and archaic U.S. regulatory structure for what it is. Regulatory gaps and black holes should no longer grow and thrive. It is time for the Congress to create comprehensive regulators who can ably assess and economically regulate, if necessary, the entirety of the U.S. financial market. Financial regulators should be provided the tools to meet, and perhaps prevent, the next crisis.

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[i] These institutions are the Commodities Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Federal Reserve System, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, Public Company Accounting Oversight Board, and the Securities and Exchange Commission.

[ii] The gross market value of these derivatives was $20.3 trillion. See BIS Quarterly Review, Dec. 2008, available at http://www.bis.org/statistics/derstats.htm.

[iii] See Standard & Poors, Under Fire, Rated Hedge Funds Will Likely Retool And Rise Again, Oct. 27, 2008, available at http://www.thehedgefundjournal.com/research/s-p/under-fire-rated-hedge-funds-will-likely-retool-and-rise-again.pdf. See also Kerry Grace, Hedge Fund Assets Cratered in 2008, The Wall St. J., Jan. 13, 2009.

[iv] See GAO Report, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, GAO-09-216 (Jan. 8, 2009).

[v] See Gary Gorton, The Panic of 2007, at 3 (Aug. 4, 2008), available at http://www.kc.frb.org/publicat/sympos/2008/gorton.08.04.08.pdf. See also Atif Mian & Amir Sufi, The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis (May 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1072304.

[vi] See Federal Reserve Board, Inside MBS & ABS.

[vii] See Patricia A. McCoy & Elizabeth Renuart, The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending, in Borrowing to Live: Consumer and Mortgage Credit Revisited 110 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008).

[viii] See Basel Committee on Banking Supervision, Bank for International Settlements (2008), The Joint Forum, —Credit Risk Transfer,‖ Consultative Document (April). See also Gorton, supra note v, at 19-31.

[ix] See Jennifer E. Bethel, et al., Law & Economic Issues in Subprime Litigation, at 15-16 (Mar. 2008).

[x] See Asset Backed Securities, Securities Act Release No. 8518 (Jan. 7, 2005).

[xi] See Richard Mendales, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown and How to Fix It (2008).

[xii] 15 U.S.C. §78o-7(c)(2).

[xiii] See President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (Mar. 2008).

[xiv] See Patricia A. McCoy, Turning a Blind Eye: Wall Street Finance Of Predatory Lending, 75 Fordham L. Rev. 2093 (2007)

[xv] See John P. Hunt, Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement (Sept. 5, 2008), available at http://ssrn.com/abstract=1267625.

[xvi] See Benjamin J. Keys, et al., Did Securitization Lead to Lax Screening? Evidence from Subprime Loan (Apr. 2008), available at ssrn.com/abstract=1093137.

[xvii] Gorton, supra note v.

[xviii] See Bradley Keoun, Citigroup's $1.1 Trillion of Mysterious Assets Shadows Earnings, Bloomberg.com, Jul. 13, 2008.

[xix] See U.S. Securities and Exchange Commission, Office of the Inspector General, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, at 120 (Sept. 25, 2008).

[xx] See Securities and Exchange Commission, Chairman Cox Letter to Basel Committee in Support of New Guidance on Liquidity Management (Mar. 20,2008), available at http://sec.gov/news/press/2008/2008-48.htm. See also Steven M. Davidoff & David Zaring, The Big Deal: The Government's Response to the Administrative Crisis (Nov. 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1306342.

[xxi] See Christopher Condon, Reserve Primary Money Fund Falls Below $1 a Share, BLOOMBERG, Sep. 16, 2008, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aAj1pHOSthQA&refer=home.

[xxii] See Diana B. Henriques, Treasury to Guarantee Money Market Funds, N. Y TIMES, Sept. 19, 2008.

[xxiii] See Department of the Treasury, Treasury Announces Guaranty Program for Money Market funds (Sept. 19, 2008), available at http://www.treasury.gov/press/releases/hp1147.htm.

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[xxiv] I also do not offer an opinion on whether saving Lehman would have avoided the panic – certainly the credit markets were frozen at the time and the deleveraging and losses Lehman heralded would have occurred but over a longer period. Nonetheless, the hasty fall of Lehman may have brought its own excess loses and has been estimated to have cost $75 billion. See Jeffrey McCracken, Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value, The Wall St. J., Dec. 29, 2008.

[xxv] See Monica Langley, et. al., Bad Bets and Cash Crunch Pushed Ailing AIG to Brink, WALL ST. J., Sept. 18, 2008, at A1.

[xxvi] See John C. Coffee & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea (Dec. 2008), available at http://ssrn.com/abstract=1309776.

[xxvii] See SEC Inspector General Report, supra note xix, at 2.

[xxviii] Id. at ix-xi.

[xxix] See Big Deal, supra note xx.

[xxx] See, e.g., Jon Hilsenrath, et al., Paulson, Bernanke Strained for Consensus in Bailout, The Wall. St. J., Nov. 10, 2008.

[xxxi] See Robert F. Bruner and Sean D. Carr, The Panic of 1907: Lessons Learned From the Market's Perfect Storm (2007).

[xxxii] The gross market value of these derivatives was $3.172 trillion. See The BIS Quarterly Review, supra note ii.

[xxxiii] In the case of CDSs the promoters of this product were able to obtain a congressional bar on their regulation while simultaneously benefitting from the rulings of a number of state insurance commissioners that these products were not insurance, leaving them largely unregulated. Notably, under the McCarran-Ferguson Act insurance regulation is left specifically to state regulation.

[xxxiv] See, e.g., Larry Cunningham and David Zaring, Three or Four Models of Financial Regulation (working draft on file with author).

[xxxv] See, e.g., Howell E. Jackson, A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States (Nov. 12, 2008), available at http://ssrn.com/abstract=1300431.

[xxxvi] See, e.g., The Department of Treasury, Blueprint for a Modernized Financial Structure (2008).

[xxxvii] Id.

[xxxviii] See, e.g., Roberta Romano, The Political Dynamics of Derivative Securities Regulation, 14 Yale J. Reg. 279 (1997).

[xxxix] GAO Report, supra note iv, at 72 (Letter from Denyette De Pierro to Orice M. Williams on behalf of the American Bankers Association, dated December 19, 2008).

[xl] See Steven M. Davidoff, Regulating Listings in a Global Market, 86 N.C. L. Rev. 89 (2007)

[xli] Cost Benefit analysis has widespread use and proponents as an appropriate economic regulatory tool even in extreme circumstances. See Cass R. Sunstein, Worst-Case Scenarios (2007).

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Testimony of Robert E. Litan[1]

Senate Committee on Homeland Security and Governmental Affairs

Where Were The Watchdogs? Systemic Risk and the Breakdown of Financial Governance

March 4, 2009

Mr. Chairman, Senator Collins, and other members of this Committee: Thank you for asking me to testify today on what could not be a more important issue facing the country in the wake of the current financial and economic crisis -- how our policies and institutions can do a better job in the future of reducing systemic risk in the financial system.

Specifically, I will address and answer the questions posed in your invitation:

--Do we need a systemic risk regulator (SRR)? Yes.

--Can the monitoring and response to systemic risks be accomplished within our existing regulatory structure, specifically by the Federal Reserve, or by some new entity? Ideally, I would like to see all federal financial regulatory activities consolidated in two agencies, a financial solvency regulator and a federal consumer protection regulator, with systemic risk responsibilities being assigned to the solvency regulator. As a second-best option, I would give clear systemic risk oversight authority to the Fed, an option which is better than either creating a new agency just for systemic risk or regulating through a "college" of existing financial regulators.

--If a systemic risk regulator is to be authorized, what should be its mandate? The SRR should have oversight of all systemically important financial institutions (SIFIs), although the nature and details of this oversight should take account of the differences in types of such institutions (banks, large insurers, hedge funds, private equity funds, and financial conglomerates). The SRR (or existing financial regulators should no systemic risk regulator be designated) should also regularly analyze and report to Congress on the systemic risks confronting the financial system.

--There are legitimate challenges associated with assigning any agency the awesome responsibility for reducing systemic risk. But after surveying the alternatives, I have concluded that policy makers have no other choice. As long as there are financial institutions whose failure could lead to calamitous financial and economic consequences, and thus invite all-but-certain federal rescue efforts if the threat of failure is real, then we must have some arm of the federal government oversee systemic risk and do the best we can to make that oversight work.

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[1] Vice President, Research and Policy, The Kauffman Foundation and Senior Fellow, Economic Studies and Global Economics Programs, The Brookings Institution.

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--Finally, while the United States should continue to cooperate with governments of other countries, notably through the G-20 process, in reforming financial systems, we should not wait for international agreements to be in place before we get our own financial house in order.

In reaching these conclusions, I draw on several recent reports I have prepared over the past year with colleagues at the Brookings Institution, and which are available on the Brookings website (www.brookings.edu), and on highly useful conversations with my colleagues and grantees of the Kauffman Foundation and with other financial policy experts.[2]

I advance the views I express here with humility. Although I have spent most of my professional career studying the financial industry, the magnitude of recent events is so far beyond anything I could have imagined several years ago that I – and I believe all of us, if we are honest – cannot be fully confident that the "fixes", both in the short and long run, that we discuss and that the Congress and our regulators eventually adopt will be ideal and immutable. We should all be open to making mid-course corrections, as events continue to unfold, as we learn more, and reflect on what we have learned.

How We Got Here

Before outlining how I reach the conclusions to the specific questions you have posed, it is useful to review briefly how we got into this mess, and then to discuss why dealing with systemic risk is now so important.

As the Committee is well aware, countless words have now been written – and surely more will follow – about the causes of the crisis. They include a widespread belief by private and public actors that residential real estate prices would continue rising forever and various government policies and institutions that encouraged home ownership to an excessive degree.

Each of these factors is certainly important, but I believe we still could have avoided much, if not all, of crisis we are now enmeshed in had not the two pillars governing the safety of our financial system – market discipline and regulatory oversight – failed, and had our financial and economic system not become so leveraged.

The Failure of Market Discipline: Markets are the best institution ever invented for allocating private sector resources, but they only work when they are governed by the right rules: to ensure there is sufficient information for market participants to understand the risks and rewards of what they are buying, and to make sure they have their own money at risk, or "skin in the game." Moreover, our entire financial system was put at risk because key financial institutions were allowed to operate with so much leverage, at

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[2] See "The Great Credit Squeeze" (with Martin Baily and Douglas Elmendorf), May 2008; "The Origins of the Subprime Mortgage Crisis" (with Martin Baily and Matthew Johnson), "Fixing Finance: A Roadmap for Financial Reform" (with Martin Baily), February 2009; and "Regulating Insurance After The Crisis" (March, 2009).

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a time when loan losses have soared. Consider the following ways in which market discipline was undermined or undercut at each stage of the subprime mortgage lending process, where our troubles began:

--Homebuyers with subprime credit ratings were permitted to finance their purchases with little or no money down, with no documentation of their income or assets, and to qualify for loans at low teaser rates (rather than higher reset rates). Mortgage documents and required disclosures also were and continue to be highly complex, and thus not fully understood by too many borrowers.

--Mortgage lenders could easily sell the subprime mortgages they originated to intermediaries that packaged the loans into securities, which were sold to private investors and to the two housing government-sponsored enterprises, Fannie Mae and Freddie Mac. Neither the original lenders nor many of the securitizers retained any portion of initial loan and thus had little incentives to ensure the credit-worthiness of borrowers.

--The new securities that were backed by the subprime mortgages, collateralized debt obligations (CDOs), were highly complex, and as it turned out, poorly understood by the ratings agencies that assigned portions of them AAA ratings and by investors who bought the securities on the strength of these ratings, despite the lack of transparency of the ratings process. Likewise the monoline bond insurers made similar mistakes – using a limited historical period for assessing the default experience on subprime mortgages – in providing insurance to back the CDOs (the insurers also lacked sufficient capital to support this new activity).

--The GSEs that bought CDOs were permitted to operate with much greater leverage than commercial banks, which helps explain why they became insolvent when housing price declines triggered sizeable losses on subprime and eventually even prime mortgages the GSEs held in portfolio or had securitized and guaranteed. Meanwhile, neither the shareholders nor the long-term debt holders of the GSEs effectively constrained their risk-taking, which also was encouraged by aggressive affordable housing goals.

--Commercial banks were able to effectively leverage their investments in CDOs beyond what was permitted by prevailing capital standards by having supposedly off-balance sheet "structured investment vehicles" (SIVs) buy the securities. The banks that created these SIVs are now suffering under the weight of the heavy losses from the SIVs, which the banks had to rescue when the commercial paper market refused to finance the SIV's mortgage-related investments.

--The once formerly proud independent investment banks were allowed to leverage their capital more than 30 times, all the while funded by short-term money that took flight last September, pushing these institutions to become regulated commercial banks. Notably, neither the shareholders nor the creditors of these institutions effectively constrained their risk-taking.

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--While credit default swaps, or loan insurance, provide a useful hedging function for investors, it is important for the health of the financial system that the issuers of these contracts have sufficient resources to honor them. AIG clearly did not. As a result, it has so far cost the Fed $150 billion to make good on the company's CDS contracts and other obligations, all because of the fear of systemic risk – a subject I will discuss in greater detail shortly – if AIG's creditors had not been protected.

The Failure of Regulatory Oversight: It is clear not only that market discipline and the rules governing it failed to prevent the current crisis, but our bank and other financial regulators also fell short. I will not belabor the obvious, but where was the supposed improvement in the oversight of bank risk management we were promised by the new Basel capital standards? Our largest banks that are now in trouble clearly were able to take enormous risks despite the daily presence of on-site bank examiners. There also clearly was a failure to set minimum borrower standards for subprime mortgages (whether or not the Fed had the legal authority to do so, it could have asked Congress for such authority, or Congress could have given it, when the no down-payment, no doc loans that never should have been allowed became so prevalent).

Summary: There is widespread agreement on the need to strengthen our financial regulatory framework so that we are far less exposed to the kind of financial and economic crisis we are now experiencing without at the same time chilling innovation and prudent risk-taking that are essential for economic growth. The best way to do that is to restructure and strengthen both of the pillars upon which an efficient and safe financial system must rest: *market discipline and sound regulation.*

It would be a major mistake to conclude that just because each of these pillars failed to prevent the current crisis either one now should be jettisoned. Neither pillar alone can do the job. Market discipline requires rules, and these rules must be enforced. Furthermore, if the federal government and thus taxpayers are potentially always on the hook for massive financial system failures – or systemic risk, the issue to which I turn next – then it is both logical and necessary that the federal government oversee the safety, in some manner, of the institutions that give rise to systemic risk.

At the time same, we need to recognize that regulators, like those they supervise, are human beings, capable of mistakes. That is why regulators need a helpful boost from market discipline, where it can be harnessed effectively and safely. Later I suggest how this can be done. Furthermore, regulators can and should be insulated from undue outside pressure to ease their solvency standards or to refrain from tightening them as economic situations warrant. I also suggest how this can be done, too.

Do We Need A Systemic Risk Regulator?

There is an especially urgent need for financial reform because recent events have underscored the dangers of "systemic risk" – the threat posed to the orderly functioning of the financial system (and by extension, the entire economy) from the failure of one or

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more financial institutions simultaneously or in close time proximity. For example, the inability of a large financial institution to pay its creditors could force them into bankruptcy or to significantly curtail their activities. Likewise, if the short-term uninsured creditors of one large financial institution are not paid, short-term creditors of other similar financial institutions may be unwilling to roll over their loans or extend new credits, bringing down these other institutions. It was the fear of systemic risk, after all, that motivated the various federal rescues: the forced sale of Bear Stearns to J.P. Morgan Chase, the Fed's takeover of AIG, the conservatorships established for the housing GSEs, the temporary expansion of deposit insurance for bank deposits, the extension of federal guarantees to money market funds, and the creation of the Troubled Asset Purchase Program (TARP) to support the banking system. Likewise, the Fed has greatly expanded its balance sheet – lending in a variety of innovative ways and purchasing assets – in an effort to keep fear from paralyzing the nation's credit markets.

Clearly, no one ever wants something like we are going through ever to happen again. And yet, as Fed Chairman Bernanke and Treasury Secretary Geithner, among others, have pointed out, our current financial regulatory structure is institution-specific. That is, regulators are charged with overseeing the safety and soundness of individual financial institutions, but none is held responsible for monitoring and assuring *system-wide* stability.

Some may say that through its monetary policy activities, the Federal Reserve can and should reduce systemic risk, by restraining asset price bubbles, and that nothing more is required. Indeed, there has been a vigorous debate among monetary economists for some time over whether the Fed could do this even if it tried. Regardless of how this debate is resolved, the Fed and the country clearly would be better off if someone somewhere had more than policy tool – in addition to monetary policy -- to reduce systemic risk.

I therefore agree with those who have called for appropriate regulation to reduce the exposure of our financial and economic system to failures of what have come to be called "systemically important financial institutions" (or "SIFIs). No agency has that explicit authority and responsibility now. This must change, and I outline how shortly.

At the same time, it is important that we all be aware of the limits of what can be done and realistically expected of any systemic risk regulator. Systemic risk will exist as long as there are financial institutions sufficiently large and interconnected with the rest of the financial system and the economy so that their failure could lead to many failures or significant financial disruption. It is unrealistic, therefore, to expect that systemic risk can be eliminated.

Likewise, history has shown time and again that asset price bubbles are endemic to market economies. Often bubbles are associated with some new technology, which many entrepreneurs and investors embrace in the hope of being one of the few winners after others are shaken out by competition. Well before the Internet boom and bust, this happened with automobiles, telephone companies, and other breakthrough technologies.

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It would be a mistake for government to try to second guess the market each time one of these technological bubbles occurs, and to try to snuff it out or contain it. In the process, government could snuff out the next Microsoft, Apple or Intel.

What has made this crisis different from previous technological bubbles, however, *is that it was preceded by an asset (housing) price bubble that was fueled by a combination of excesses in the financial sector*: imprudent mortgage lending, excessive leverage by financial institutions, and imprudent insurance or insurance-related activities (unsound bond insurance underwriting and inadequate collateral and capital backing credit default swaps in the case of AIG). As my Brookings colleague Alice Rivlin has suggested, these are the kinds of activities to which a systemic risk regulator can and should alert the Congress, other regulatory agencies and the public. More broadly, as I discuss in more detail below, the systemic risk regulator should have special oversight responsibilities with respect to SIFIs, to ensure that they have the financial resources – both capital and liquidity – to withstand reasonably severe adverse economic shocks, both to the economy generally and to their important counterparties.

Who Should It Be?

I see four alternatives by which systemic risk regulation can be carried out.

Regulatory Consolidation/Solvency Regulator as the Systemic Risk Regulators: Ideally the Congress would consolidate our current multiple financial regulatory agencies into just two: one for solvency, the other for consumer protection. The solvency regulator would oversee and supervise all banks (and thrifts, assuming their charter is retained, which I believe it should not be) and systemically important insurers. The solvency regulator would also have a division specially charged with oversight of all SIFIs. The consumer protection regulator would combine the current activities of the SEC and the CFTC, the current consumer protection activities of the federal banking agencies, and also the relevant financial consumer protection responsibilities of the FTC.

The Treasury Department under Secretary Paulson outlined a similar plan, except for designating the Federal Reserve as a separate systemic risk regulator, with broad but ill-defined powers. Many have drawn the analogy between the Fed in this role as the equivalent of a "free safety" defensive back in football, with broad discretion to pick up the "uncovered man", or in this case the systemic financial issues that otherwise might fall through the cracks of other regulators.

The advantage of this first option is that it is clean, logical, and frankly makes the most sense. It would eliminate current regulatory overlaps and jurisdictional fights, which now are supposed to be ironed out by the President's Working Group on Financial Markets.

I realize, of course, that under any scenario, the Fed still remains on the financial hook to finance the rescue of any SIFIs, should ordinary and systemic risk oversight fail (I am assuming here that, after its current and ongoing experience with the TARP,

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Congress is unlikely or be very unwilling to authorize another TARP-like vehicle under Treasury's administration to deal with future crises). For this reason, the Fed should have regular consultations and interactions with the solvency regulator, including the right to receive in a timely manner all information about SIFIs that it believes is necessary. These interactions would inform the Fed's monetary policy activities, and would ready the Fed for any rescues that might be required (although some of the planning for these events can and should be done beforehand, as I will discuss in the next section).

But as President Truman's famous "The Buck Stops Here" sign makes amply clear, in any organization the buck must stop somewhere. Otherwise, not only will regulators be prone to fight, but regulated financial institutions can be confused and subjected to conflicting demands, especially at times of financial stress (according to recent press accounts, this appears to be a significant problem for Citigroup, and possibly other banks that have received TARP funds).[3] Under this first ideal option, therefore, the Buck Stops Here principle means that the solvency regulator, and not the Fed, would have the clear authority and responsibility for overseeing all federally regulated financial institutions, including SIFIs. The solvency regulator would also be responsible for producing regular reports to Congress about systemic risk (drawing on the expertise of the Fed and the President's Council of Economic Advisers).

The Federal Reserve: I am not so naïve as to think that something like the Paulson plan (minus the free safety role for the Fed) will be implemented any time soon. Accordingly, as a second-best or fallback solution, I agree with those who say that oversight of systemic risk should be given to the Federal Reserve System. After all, the Fed is likely to pay all or most of the bill for the failures of SIFIs in the future; at a minimum, the Fed's monetary policy goals can be frustrated or diverted by the failure of such institutions. As a result, the Fed is a logical, and probably the most politically feasible, choice for systemic risk regulator.

In my view, if the Fed is chosen as the systemic risk regulator (SRR), it should not be as a "free safety", as envisioned by the Paulson Treasury. Giving the Fed broad but vague responsibilities is a recipe for agency infighting before the fact and for finger-pointing after the fact. Put simply, the free safety model violates the Buck Stops Here principle. Instead, if the Fed is assigned systemic risk regulatory responsibilities, then it should have sole authority over solvency and related reporting requirements relating to these institutions.

Admittedly, assigning oversight of systemic risk, and specifically of the activities of SIFIs, to the Fed is not without significant risk, but I believe most, or all, of these challenges can be met. One such risk, as some critics of this option have pointed out and which I have just noted, is that making explicit the Fed's responsibility for preventing risk could compromise its pursuit of monetary policy. For example, the Fed could clamp down on asset bubbles, but in the process generate higher unemployment (which almost certainly have happened earlier this decade if the Fed had tried to prick the housing

[3] See Monica Langley and David Enrich, "Citigroup Chafes Under U.S. Overseers," *The Wall Street Journal*, February 25, 2009, p. A1.

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bubble only through monetary policy). Conversely, in bailing out creditors of failed institutions or an in effort to provide liquidity to the market during a financial crisis, the Fed could lay the groundwork for future inflation (which many also believe to be a concern now).

But the reality is that the Fed already has *implicit it not explicit* authority for containing systemic risk – that is, after all, one of the main jobs of a lender-of-last-resort. *Giving the Fed the appropriate regulatory tools to contain the risk posed by SIFIs would make its monetary policy job easier, not harder.* Thus, had the Fed tightened standards for subprime mortgage origination earlier in the decade, it would not necessarily have needed tighter monetary policy to restrain housing price inflation.

A related concern is that providing the Fed with explicit systemic risk responsibility could compromise its independence, which evidence has shown to be important to carrying out effective monetary policy, especially when the Fed tightens money in order to contain inflation. The argument here presumably is that Congress and/or the President would be emboldened to criticize and thus effectively constrain the Fed in its monetary policy activities if the Fed were to fall short in its regulatory duties. The response to this is that the markets clearly would frown upon political attacks on the Fed's independence. This is why Presidents have learned to refrain from criticizing the Fed, and why I believe Congress keeps it hands off too.

There is more substance to the critique that Congress and/or the President could put pressure on the Fed in carrying out its *regulatory activities.* Specifically, in the future, it is quite possible, if not to be expected, that SIFIs under the regulation and supervision of the Fed could enlist some in Congress and or the Administration to inappropriately lighten the Fed's regulatory stance when it may ill-advised to do so, or conversely to refrain from tightening its regulatory standards to keep a bubble from expanding.

My answer to this critique is that this risk already exists under the current regulatory structure: we saw, for example, before this crisis how a number of large banks objected to potential higher capital requirements under the Basel II regime (which I discuss and criticize for other reason at the end of this testimony). I don't see how vesting more regulatory authority in the Fed makes this risk any worse. The only concern is whether it spills over into compromising the Fed's monetary policy functions, a critique I have just answered. Furthermore, the Fed or any systemic risk regulator can insulate itself from political pressure by introducing a more automatic system of counter-cyclical capital standards than now exists, as I discuss shortly.

Yet another fear that might be lodged against the Fed is that it might be excessively risk averse and regulate too heavily. Given what has just happened, about agency given systemic risk responsibility is likely to be risk averse. This objection goes more to regulation per se, not just by the Fed, and it is one I also address shortly below.

Still another challenge for the Fed, if given systemic responsibility, would be to build a staff appropriate to the task. Critics will argue that the Fed now only has

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supervisory expertise for banks, but not for other financial institutions that might be deemed to be SIFIs, such as large insurers, hedge and private equity funds, and that for this reason, it is not an appropriate SRR. But this same critique applies to any agency that would be given solvency regulatory duties with respect to any non-banks not now regulated at the federal level.

In any event, I believe the alleged staffing problem is a solvable one, especially in the current job market, which has seen layoffs of many qualified individuals in the financial sector. Some of these individuals would be grateful for secure, interesting employment at an SRR. To anticipate a potential objection to relying on private sector expertise, not everyone who once worked in finance is a crook or is responsible for our current mess. The Fed (or any SRR) also should be able to draw supervisory personnel for large banks in particular from the Comptroller of the Currency, which is already supervising these institutions. In addition, law and accounting firms, among others, would be fertile sources of potential new regulatory recruits.

Finally, some may fear that because the Fed's budget is effectively off limits to the President and to the Congress – the Fed pays its expenses out of the earnings from its balance sheet and returns the excess to the Treasury – giving the Fed more regulatory responsibility would permit it to exercise too much discretion and to spend too much money without effective political oversight. If Congress believes this to be a significant problem, it could always wall off and subject to the annual appropriations process the purely regulatory (and related research) functions of the Fed, while allowing the Fed to retain its budgetary freedom with respect to its monetary policy functions to operate as they are now. I suggest that if this done that the Fed be allowed to fund its regulatory (and related research) activities through supervisory assessments on the SIFIs subject to its jurisdiction.

A New Agency: A third option for the systemic risk regulator is to create an entirely new agency, whether or not the other financial regulatory agencies are consolidated in some manner. As with the first option, the Fed could have an advisory role in this new agency, and should in any event be given the same timely access to the information collected by this agency as the agency itself has.

My main objection to this approach is that it would add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions. This concern would be mitigated by consolidating the financial regulatory agencies, as in the first option. But still the activities of an SRR are fundamentally identical to the solvency regulatory functions now carried out by the banking agencies, including the Fed. Why go to the trouble of creating yet another agency with similar skills to those that already exist?

A College of Existing Regulators: A fourth option is to vest systemic risk regulatory functions in a college of existing regulators, perhaps by giving formal statutory powers to the President's Working Group on Financial Markets, as well as additional regulatory authority for SIFIs that are not currently regulated by any federal

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financial regulatory agency (insurers, hedge and private equity funds). This option may be the most politically feasible – since it does not disturb the authority of any individual financial regulatory agency, while augmenting their collective authority – but it is also the least desirable in my view.

A college of regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing. It also keeps too many cooks in the regulatory kitchen and thus invites coordination difficulties. Admittedly, creating a college of regulators may reduce these problems, but I doubt that it would eliminate them.

What Should The Systemic Risk Regulator Do?

It is one thing to identify the systemic risk regulatory (SRR), it is quite another to define precisely what it is supposed to do. Here I will freely admit that much more hard thinking needs to be done about the scope of the SRR's duties, and for that reason, I would suggest that the Congress draft any authorizing legislation in broad terms and permit the designated agency to fill in most of the details by rulemaking or less formal guidance, subject to Congressional oversight. I nonetheless will preview some of the key issues that Congress and/or the agency must be resolve and how I tentatively would advise doing so.

First, the SRR's mission must be clear. In my view, that mission should be to reduce significantly the sources of systemic risk or to minimize such risk to acceptable levels. For reasons already given, the goal should not be to *eliminate* all systemic risk, since it is unrealistic to expect that result, and an effort to do so could severely clamp down on socially useful activity.

Second, there must be criteria for identifying SIFIs. The Group of Thirty suggested that the size, leverage and degree of interconnection with the rest of the financial system should be the deciding factors and I agree. The test should be whether the combination of these factors means that the failure of the institution poses a significant risk to the stability of the financial system. I anticipate that the application of this definition would cover not only large banks (for starters, the nine largest institutions that were required to accept TARP funds at the outset), but also large insurers, and depending on their leverage and counter-party exposures, hedge and private equity funds. It is also conceivable one or more large finance companies could meet the test. And presumably the major stock exchanges and clearinghouses, as well as the contemplated clearinghouse(s) for credit default swaps, would qualify.

I am aware of the predictable counter-argument that no hedge fund or private equity fund should be designated and regulated as a SIFI, on the ground that so far what problems have surfaced among these funds have been resolved in an orderly fashion without threatening the financial system. True enough. But our regulators also don't know enough what's out there because there is no comprehensive reporting by these funds, or at least those above a certain size. I envision the SRR working with an

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appropriate federal financial regulator – presumably the SEC or its successor (a merged agency with the CFTC or a broad consumer protection regulator) – to establish reporting requirements that would enable the SRR to identify if any of these funds indeed poses a significant systemic risk. Had we had such a system in place well before LTCM grew to be so leveraged, it is possible, if not likely, that that fund would never have blown up. The problem now is that we really don't know if there is another LTCM in waiting, and this simply must change.

As for the regulation of insurance, I have just completed an analysis of this subject that is being posted on the Brookings website today. It is quite likely a number of our largest life and property-casualty insurers would satisfy the SIFI criteria, and thus should be regulated by the SRR. *This would mean that some insurers would be regulated for solvency purposes at the federal level for the first time.* I believe that other insurers (excluding health insurers) should be given the option to be regulated at the federal level as well (though not by the SRR, but by a new general financial solvency regulator, or failing the creation of such a body, then by a new office of insurance regulation, analogous to the Comptroller of the Currency for banks).

It is critical, however, that federal law preempt the application of state laws and rules, such as rate regulation, to federally regulated insurers. Otherwise, states would be too easily tempted to force insurers to charge rates below actuarially appropriate levels, knowing that insurer solvency is no longer a state problem but a federal one. Where rate suppression exists, it can endanger the solvency of insurers and/or encourage them to cut back or drop their coverage, as a number of insurers already have done in Florida. Neither outcome is consumers' interest. It is time to entrust the pricing of insurance, an industry with a low degree of concentration, to the marketplace, as is the case for other financial and non-financial products.

Third, the process for identifying SIFIs should be clear. Institutions so designated should have some right to challenge, as well as the right to petition for removal of that status if the situation warrants. For example, a hedge fund initially highly leveraged should be able to have its SIFI designation removed if the fund substantially reduces its size, leverage and counter-party risk.

Fourth, the nature of the regulatory regime for SIFIs must be specified. Here I principally have in mind standards for capital (leverage) and liquidity (both on the asset and liability sides of the balance sheet), as well as reporting requirements, both for the public and for the regulator (the latter should be able to receive more detailed and proprietary information than is appropriate for the public, such as the identity of counter-parties and the size and nature of the exposure to specific counter-parties). These requirements should take account of differences in the types of institutions and their activities. For example, what is an appropriate capital and liquidity standard for banks is likely to be different than for systemically important insurers, hedge and private equity funds, and clearinghouses and exchanges.

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Broadly speaking, however, because of the systemic risks they pose, the SRR should begin with the presumption that the capital and liquidity standards for SIFIs should be *tougher* than those that apply to financial institutions that are not SIFIs. Tougher requirements are also appropriate to meet the obvious objection that identifying SIFIs in advance leads to moral hazard. Appropriate regulation is required to offset this effect.

In this regard, the SRR should also consider reducing the pro-cyclicality of current capital requirements – which constrain lending in bad times and fail to curb it in booms -- but only if minimum capital requirements at least for SIFIs are gradually increased in the process, and if the criteria for moving the standards up or down are clearly announced and enforced. Otherwise, if regulators have too much discretion about when to adjust capital standards, they are likely to relax them in bad times, but buckle under political pressure not to raise them in good times. A clear set of standards for good times and bad would remove this discretion and also insulate the regulators from undue pressure to bend to political winds when they shouldn't.

Fifth, the SRR will need to supervise the institutions under its watch, not only to assure compliance with applicable capital and liquidity standards, but as suggested by the Group of Thirty, also to assure that the institutions are adhering to best practices for risk management, including daily, if not hourly, exposures to their largest counterparties.[4] As I noted earlier, the SRR should be able to attract supervisors from the OCC for large bank supervision, and from a very soft job market for finance professionals generally. Supervisory costs should be funded from assessments on the SIFIs. Indeed, there is no reason why the entire budget of the SRR could not be funded in this manner.

Sixth, as we have all witnessed, regulators are human beings, capable of mistakes. It is also unrealistic to expect them to clairvoyant, regardless of how much beefed up training and new blood they get in the wake of this current crisis. For this reason, it is absolutely essential that regulators look to *stable sources of market discipline* to provide market-based signals of when institutions under their watch may be developing problems. By stable, I mean capital that can't easily run, like uninsured deposits in a bank or commercial paper or short-term repurchase agreements (repos) for other types of financial institutions. Common shareholders also cannot "run" – by demanding a return of their funds – but they do not have the ideal risk profile for discouraging imprudent risk-taking by managers, because they get all of the upside, but have limited downside risk.

One ideal source of market discipline is uninsured, unsecured long-term debt, or subordinated debt, issued by financial institutions. Such debt has no upside beyond the interest payments it promises, and thus its holders are likely to be more risk averse than common shareholders (or certainly than insured depositors). Under current bank capital rules, however, banks are allowed but not required to issue such debt. As and I and a

[4] In this regard, the SRR should draw on the excellent risk management practice suggestions offered by the private sector Counterparty Risk Management Policy Group (CRMPG) and the Institute of International Finance.

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number of academic scholars have been urging for years, large banks should henceforth be required to back a certain minimum portion (say 2%) of their assets with subordinated debt. The interest rates on this debt would provide important early market-based signals to regulators about the possible deterioration in the bank's health. Indeed, the SRR should consider extending this subordinated debt requirement to the large insurers identified as SIFIs. One additional idea to consider is whether to make the debt convertible into equity should the SIFI's financial position fall below a certain threshold, as Harvard Business School professor (and now currently National Economic Council staff member) Jeremy Stein has suggested. And still another idea is for the SRR to look to the prices of credit default swaps – yes those maligned financial instruments – as a source of market-based information (CDSs are nothing more than insurance contracts on the default of an institution's debt, and thus the prices at which they trade can be powerful sources of information about what market participants, with their money on the line, believe about the financial prospects of the institution).

In the wake of the recent bailouts, one legitimate question is whether there is any role left for market discipline in the financial system, at least with respect to SIFIs. I believe there is, and must be, since we cannot put all of the weight of monitoring and enforcing the health of our financial system on regulators. The key is to harness the discipline of providers of capital to SIFIs that the market credibly believes will not be bailed out in a future crisis. Subordinated debt holders meet this test. CDS counter-parties also can meet this test if appropriate regulation is brought to this market.

Which brings me to point number seven: the CDS market, and indeed the entire over-the-counter derivatives market, poses systemic risks, as the failure of AIG so clearly demonstrates (and who knows what other risks in these markets are lurking?). The establishment of central clearinghouses, which has been active discussion, should mitigate these risks, but only if any derivatives clearinghouse itself is also well capitalized and has sufficient liquidity. This is the reason that such a clearinghouse presumptively should be viewed as a SIFI and regulated as such, although the SRR may want to share its work here with other agencies with expertise in this area, notably the current SEC and CFTC (How this would be accomplished is an important detail that must be worked out).

But even a well-capitalized and supervised central clearinghouse for CDS and possibly other derivatives will not reduce systemic risks posed by customized derivatives whose trades are not easily cleared by a central party (which cannot efficiently gather and process as much information about the risks of non-payment as the parties themselves). I do not have an easy answer to this problem, except to suggest that the SRR, in conjunction with the SEC and CFTC, consider ways to set minimum capital and collateral rules for sellers of these contracts. At a minimum, more detailed reporting to the regulator by the participants in these customized markets should be on the table.

Finally, and I cannot stress heavily enough how important this is, all SIFIs under the watch of the SRR should be required to file an "early closure and loss sharing plan" – a pre-packaged bankruptcy plan without the extensive, costly and time-consuming

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bankruptcy process itself -- that would go into effect upon a regulatory determination that the institution is troubled, but not yet insolvent. In effect, we have had such a "prompt corrective action" system for banks since the passage of FDICIA in 1991. As this crisis has illustrated, PCA hasn't worked perfectly for banks, but it did force the regulators to induce many banks at an early stage of the crisis to raise capital from the private markets (before they effectively shut down). This is a better outcome than occurred in the 1980s when regulators exercised "regulatory forbearance" when confronted with the threatened failure of the nation's largest banks due to their troubled sovereign debt and other loans. The fact that PCA did not keep the largest banks from having to be rescued by the TARP is an argument for raising the threshold at which early corrective action is required, not for abandoning the concept of mandated early intervention.

Accordingly, high on the "to do" list of any future SRR is to extend PCA to all the SIFIs under its watch. This could be implemented by imposing minimum early intervention standards for all SIFIs, taking account of the differences in their businesses, or by accepting and then negotiating such early closure plans with the individual institutions. Whatever course is taken, the process must produce publicly announced statements by the SIFIs that make clear how losses of uninsured parties, including those among affiliates of the SIFI itself, are to be allocated in the event of regulatory intervention. The early intervention or closure plans should also envision a government-appointed conservator running the institution, with instructions to work with regulators to come to the least cost resolution (by sale to other parties, by separation into a "good bank/bad bank" structure, or other means).

The SRR need not, and arguably should not, be the institution that administers the resolution of failed institutions. This job could be handled by the existing FDIC, which has expertise in these matters, or by creating a new asset disposition agency of which the current FDIC would a core part.

Answers to Anticipated Objections

There will be plausible objections to implementing systemic risk regulation and putting one regulator or a group of them of explicitly in charge. Nonetheless, I believe each can be answered.

To begin, the most obvious objection is that identifying specific institutions will create moral hazard, because it will effectively signal to everyone that if these institutions are threatened with failure, the federal government will come to the rescue of at least their short-term creditors and counterparties. These critics presumably argue that it is better to return to the policy of "constructive ambiguity" which reined until this crisis: better to keep market participants guessing about whether they will be protected in order to induce them to monitor the health of the institutions with which they do business, and thereby discourage imprudent risk-taking by the managers of the institutions.

Well, guess what? In light of the extraordinary bailouts over the past year, constructive ambiguity is dead. The only large troubled institution whose creditors took a

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hit during this period was Lehman Brothers, and I believe most policy makers, in private if not in public, will admit that was a mistake (although they may also say that no federal entity had the legal authority to rescue Lehman's creditors).

In short, I believe there is no turning back. We now know that at least the short-term creditors of large financial institutions will be bailed out if the institutions run into trouble. Given this, we might well face the new set of facts and do our best to provide better capital and liquidity cushions under those institutions in advance. That is one answer to the moral hazard charge. A second answer, as I outlined earlier, is that the systemic risk regulator should consider imposing an extra dose of stable market discipline on SIFIs that is not required for smaller institutions.

A related, second objection to regulating SIFIs is that it won't work: namely, why would the SRR will do any better overseeing SIFIs than our current regulators of banks who clearly failed to stop our largest banks from literally going over the edge? How can we expect regulators, who are paid less and have less financial sophistication, than their private sector counterparts ever to keep up with them? These are legitimate questions and my best answer to them is to ask in reply: can you show me a better alternative? The events of the last couple of years could not more clearly demonstrate that the failure to more vigorously oversee the large institutions whose creditors we have ended up protecting has led to the largest bailout in American history, and certainly the most calamitous economic circumstances since the Depression. Even a half-way effective SRR over the last decade would have given us a better outcome than we have now.

I believe we can meet or do better than even that minimal standard. For a good while, the market will not buy the kinds of non-transparent securities that our financial engineers cooked up during the subprime mortgage explosion. So our regulators have some time to catch up. And, as I said, given the soft job market, the agencies should have an easier time attracting the right talent. Of course, as times get better, the agencies will need to raise salaries to keep their best personnel. Accordingly, the SRR should have more salary freedom to compete for the best and brightest in finance in the years ahead (and it would be able to pay for all this through the fees it charges SIFIs to supervise them).

A third objection is that once today's SIFIs are identified and regulated, what we are to do about tomorrow's new unregulated institutions that surely will take their place and potentially expose us to another round of financial damage? The answer is that if such institutions arise, the SRR regime will need to be expanded. Congress has a choice: give the SRR broad regulatory power now to identify and regulate such entities, which I know many fear would be giving the agency a blank check, or wait until the new institutions arise and pose a recognized danger, and then give the SRR expanded authority. The latter option, while perhaps more politically palatable, runs the risk of repeating a variation what we have just witnessed: the rise of new institutions, namely state-chartered mortgage brokers, and new complex mortgage securities, that in combination too freely originated and securitized subprime mortgages, landing us in the mess we are now in. I can easily imagine a new set of institutions in the future doing

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much the same thing, and with the political power to resist any preemptive regulation. So, if I had to err on any side, it would be to give the SRR at the outset the ability to expand its net to cover new kinds of SIFIs, subject to Congressional limitation or override. As a growing body of economic evidence is suggesting, the "default" scenario matters a lot. Here, the default position for the scope of the SRR should be more expansive than limited.

Furthermore, I would remind those who worry that the market will always invent its way around or outsmart our regulators that the regulation of finance has always been a game of cat and mouse, with the private sector mice always one step ahead of the regulatory cats. The problem exposed by this crisis is that the mice now have grown huge and can wreak havoc on a scale previously unimagined. We need to respond by getting better regulatory cats, lions if you will. The fact that this game will continue to go on is not a reason to give up entirely and let the large mice eat their way through the entire economy.

The specter of a powerful SRR no doubt will lead to another objection: that in the zeal to prevent a rerun of recent events, albeit surely in a different guise, regulators will clamp down excessively on financial institutions and risk-taking, and thus kill off or perhaps severely maim the entrepreneurial risk-taking that is the lifeblood of our economy and that is key to our future economic growth. At the Kauffman Foundation, whose mission is to promote understanding of entrepreneurship, we worry a lot about such an outcome. I nevertheless draw some comfort from several things. One is that a financial system that entails less frequent bailouts of large financial institutions will have more room for risk capital, and will be less susceptible to the kinds of episodes we are now experiencing which chill risk-taking. A second consideration is that any system of regulating SIFIs would not touch venture capital, angel groups, or individual sources of wealth which are sources of start-up equity capital for new firms, but which clearly are not SIFIs under any reasonable definition of the term.

Finally, some may reject the notion that government should assume that some financial institutions are so systemically important that their short-term creditors must be bailed out in a pinch. So presumably these critics would either retain the policy of constructive ambiguity or have the Fed and the Treasury make clear that henceforth, no more bailouts. Under such a view, without SIFIs, there would be no need for special regulation of them, beyond what exists now.

The problem with this line of reasoning is, as I have noted, that events have passed it by. I can't believe there is anyone in the markets or otherwise who would believe the government if it were now to announce such a non-bailout policy. Nor do I believe that this Fed Chairman or future Fed Chairmen would rule out rescues in order to save the financial system. In short, as I have said, constructive ambiguity is dead.

Other Constructive Steps To Contain Systemic Risk

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Even if systemic risk is to be more systematically regulated, it would be a mistake to put all of our faith in any one regulator (or college of regulators) to do all the work. Like investment professionals who counsel not putting all one's financial eggs in one basket, policy makers should use other regulatory or policy "baskets" to supplement and reinforce the measures undertaken by the risk regulator.

For example, bank regulators, including the systemic risk regulator, should be required to issue regular (annually or perhaps more frequently, or as the occasion arises) reports outlining the nature and severity of any systemic risks in the financial system. Presumably, such reports would put a spotlight on, among other things, rapidly growing areas of finance, since rapid growth tends to be associated (but not always) with future problems. Economists recently have been working hard on identifying asset bubbles, and while the results are still not perfect, they seem to be improving. In my view, bubble forecasting is not much more prone to error than hurricane forecasting. We engage in the latter, we ought to start taking warnings of the former more seriously.

Establishing early warning systems does not necessarily mean that the Federal Reserve should alter its monetary policy to prick bubbles in formation. The virtue of regulation for dampening bubbles is that it can be more targeted and surgical than the blunt instruments of open market operations or changing the discount rate.

A legitimate objection to an early warning-based regulatory system is that political pressures may be so great that policy makers will ignore them. In particular, a case can be made that had warnings about the housing market becoming overheated been issued by the Fed and/or other financial regulators during the past decade, few would have paid attention. Moreover, the political forces behind the growth of subprime mortgages – the banks, the once independent investment banks, mortgage brokers, and everyone else who was making money off subprime originations and securitizations – could well have stopped any counter-measures dead in their tracks.

This recounting of history might or might not be right. But I don't think the answer matters. The world has changed with this crisis. For the foreseeable future, perhaps for several decades or as long as those who have lived and suffered through recent events are still alive and have an important voice in policy making, the vivid memories of these events and their consequences will give a future systemic risk regulator much more authority when it warns the Congress and the public of future asset bubbles or sources of undue systemic risk.

Second, the SRR and other financial regulators should explore ways to encourage the largest financial institutions in particular, and indeed all financial actors, to tie compensation more closely to long-term performance than short-term gain. Clearly, had such compensation systems been in place earlier this decade, the volume of unsound subprime mortgages would have been far lower.

The challenge is to figure out how best to encourage long-term compensation. Exempting financial institutions from the antitrust laws so they can agree on long-term

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compensation schemes is not a good idea and could open the floodgates to petitions for other exemptions. If we keep the current, complicated system of bank and insurer capital standards (which I criticize below), one could think of setting modestly lower capital requirements for institutions that tie pay to long-term performance. My preference, however, is for regulators to take this issue into account in their review of an institution's risk management controls. Other things being equal, institutions with long-term performance packages are more likely to prudently manage their risks.

I am less enthusiastic and indeed skeptical about two other ideas for constraining future bubbles. One such idea is to subject new financial products to FDA-like safety and efficacy screening before permitting them to be used in the marketplace. This may sound nice in theory, but it is likely to be much more problematic in practice. For one thing, it is virtually impossible to predict in advance of the introduction of a new product how it will affect the economy, positively or negatively. Since regulators will be blamed for products that are later viewed to be unsound but get little or no credit for socially productive innovations, the regulatory impulse under a pre-screening system will always be to say "no." This would introduce an anti-innovation bias into U.S. finance, which however much it has been maligned because of this crisis, is nonetheless a prime U.S. competitive asset that should not be squelched but steered in a more productive direction.

The better approach for addressing the risks of financial innovations, in my view, is to regulate them in a targeted fashion if they later prove to be dangerous, much as we regulate consumer products. Had we imposed a pre-screening system on automobiles or airplanes, for example, objections certainly would have been raised that each technology could lead to unintended deaths, and for that reason each could have been banned. The same is even true for the Internet, for one easily could have imagined at the outset that criminals and terrorists would take advantage of it, just as they use our highways, banks and other accoutrements of daily life. Banning the Internet, or more accurately its commercial use, today would seem unthinkable, but in a pre-screening environment who knows what would have happened?

Finally, it may be tempting to impose size limits on financial firms, in addition to limits on leverage. Through the antitrust laws, we already have something of this kind, but only if mergers result in an excessive degree of market concentration, or in the case of monopoly, only if the firm abuses its market dominance. There are well-established and defensible criteria for applying these rules. In contrast, I know of no non-arbitrary way to limit any financial institution's size.

In fact, further consolidation among financial institutions is one likely outcome of the current turmoil. Some might say that this will aggravate the systemic risk problem. It may and it may not. Some of the institutions merging may already be so large as to be SIFIs. If the system results in mergers of SIFIs, we are likely to have fewer of them to watch over. Which is better: 10 banks each of which may be considered to be a SIFI and thus in need of extra scrutiny, or just 5 of them, but twice the size? Frankly, I don't know, and I know of no way of being sure which scenario poses the most systemic risk.

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In the end, we now live in a complicated world where we inevitably will have large financial institutions whose failure poses risks to the rest of the economy. The best we can do is harness our best regulatory resources and stable market discipline in an effort to reduce the likelihood that any one of them could fail, and to limit the concentrations of counter-party risk of these institutions. I see no better alternative.

Role for Global Cooperation

The submprime mortgage crisis has triggered widespread economic damage in the rest of the world, demonstrating if there was any doubt about this before, that the financial system today is highly globalized and interconnected across national boundaries. It is primarily for this reason that the Bush Administration agreed to the G-20 meeting held in Washington in November. Now, the Obama Administration is preparing for the follow-up meeting in London on April 2.

In principle, there is great attractiveness to at least one of the premises of the G-20 effort, namely that because finance is now global, the rules governing finance also should be global, or at the very least harmonized among the major countries. Some advocate a further step: overseeing the entire financial system, or at least the large international SIFIs, through a global regulator.

I have deep reservations about both ideas. Our recent experience with the current bank capital standards developed by the Basel Committee – the so-called Basel II rules – demonstrates why.

The Basel II revisions took roughly a decade for the participating countries to debate and finalize, and by the time they were done, they were essentially irrelevant, for the banking crisis had already begun. Beyond the excessive time that is inherent in any international rulemaking process is the inevitable complexity that such efforts are likely to entail. The Basel II rules eventually grew to over 400 pages of complex rules and formulae, none of which is necessary. We would have been far better off over the past decade with a simple (but higher) leverage requirement for our largest financial institutions, coupled with a subordinated debt requirement, which would have supplemented a simple regulatory standard with stable market discipline.

Meanwhile, the leading financial centers of the world – including the United States – are simply not ready to cede regulatory oversight to a new global body that does not even exist. If the politics that went into the development of the Basel standards is any guide – and they should be – a global regulator would be susceptible to the kind of bureaucratic and political intrigue that is out of place, and frankly dangerous, in today's fast-paced financial environment.

Having said all of this, I still believe that the United States and other countries have much to learn from each other in the way they regulate and supervise financial institutions and markets. Thus, I am all for a G-20 process that affords opportunities for

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cross-pollination of views. We also need coordination among central banks and finance ministries, of the sort that the Basel Committee already affords, especially during crises.

But when it comes to reform, I think the guiding principle should be one coined recently by the Conference Board of Canada in issuing its recommendations for financial reform: "Think Globally, Act Locally."[5] It is true that failures in U.S. regulation and oversight were major causes of the current global financial crisis (although it has since come to light that there were failures elsewhere, too, which have amplified the effects of the crisis). We should not wait, and indeed cannot afford to wait, for international consensus to fix our system. We clearly don't need or want another decade-long Basel like process to reach consensus on reform. We can and should do the fixing on our own.

[5] The Conference Board of Canada, *International Financial Policy Reform and Options for Canada: Think Globally, Act Locally*, February 2009.

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Testimony of Damon A. Silvers

Associate General Counsel

American Federation of Labor and Congress of Industrial Organizations

Hearing on Systemic Risk and the Breakdown of Financial Governance

Senate Committee on Homeland Security and Governmental Affairs

March 4, 2009

Good morning Chairman Lieberman and Senator Collins. My name is Damon Silvers and I am Associate General Counsel of the AFL-CIO and Deputy Chair of the Congressional Oversight Panel. My testimony today is on behalf of the AFL-CIO and will include a discussion of the Congressional Oversight Panel's report on regulatory reform mandated by the Emergency Economic Stabilization Act of 2008. However, my testimony reflects my views and those of the AFL-CIO, and does not necessarily reflect the views of the Congressional Oversight Panel, its chair or its staff. I have attached as appendices the regulatory reform report of the Congressional Oversight Panel, and recent statements of the AFL-CIO Executive Council addressing financial regulation.

This hearing has been called to address the question of how we should regulate systemic risk in the financial markets. The challenge of addressing systemic risk in the future is one, but by no means the only one, of the challenges facing Congress as Congress considers how to reregulate U.S. financial markets following the extraordinary events of the last eighteen months.

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Systemic crises in financial markets harm working people. Damaged credit systems destroy jobs rather than create them. Pension funds with investments in panicked markets see their assets deteriorate. And the resulting instability undermines business' ability to plan and obtain financing for new investments—undermining the long term growth and competitiveness of employers and setting the stage for future job losses. The AFL-CIO has urged Congress since 2006 to act to reregulate shadow financial markets, and the AFL-CIO supports addressing systemic risk, but in a manner that does not substitute for strengthening the ongoing day to day regulatory framework, and that recognizes addressing systemic risk both requires regulatory powers and financial resources that can really only be wielded by a fully public body.

The concept of systemic risk is that financial market actors can create risk not just that their institutions or portfolios will fail, but risk that the failure of their enterprises will cause a broader failure of other financial institutions, and that such a chain of broader failures can jeopardize the functioning of financial markets as a whole. The mechanisms by which this broader failure can occur involve a loss of confidence in information, or a loss of confidence in market actors ability to understand the meaning of information, which leads to the withdrawal of liquidity from markets and market institutions. Because the failure of large financial institutions can have these consequence, systemic risk management generally is seen to both be about how to determine what to do when a systemically significant institution faces failure, and about how to regulated such institutions in advance to minimize the chances of systemic crises.

Historically, the United States has had three approaches to systemic risk. The first was prior to the founing of the Federal Reserve system, when there was a reluctance at the federal level to intervene in any respect in the workings of credit markets in particular and financial markets in

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general. The Federal Reserve system, created after the financial collapse of 1907, ushered in an era where the federal government's role in addressing systemic risk largely consisted of sponsoring through the Federal Reserve system, a means of providing liquidity to member banks, and thus hopefully preventing the ultimate liquidity shortage that results from market participants losing confidence in the financial system as a whole.

But then, after the Crash of 1929 and the four years of Depression that followed, Congress and the Roosevelt Adminstration adopted a regulatory regime whose purpose was in a variety of ways to substatively regulate financial markets in an ongoing way. This new approach arose out of a sense among policymakers that the systemic financial crisis associated with the Great Depression resulted from the interaction of weakly regulated banks with largely unregulated securities markets, and that exposing depositors to these risks was a systemic problem in and of itself. Such centerpieces of our regulatory landscape as the Securities and Exchange Commission's disclosure based system of securities regulation and the Federal Deposit Insurance Corporation came into being not just as systems for protecting the economic interests of depositors or investors, but as mechanisms for ensuring systemic stability by, respectively, walling off bank depositors from broader market risks, and ensuring investors in securities markets had the information necessary to make it possible for market actors to police firm risk taking and to monitor the risks embedded in particular financial products.

In recent years, financial activity has moved away from regulated and transparent markets and institutions and into the so-called shadow markets. Regulatory barriers like the Glass-Steagall Act that once walled off less risky from more risky parts of the financial system have been weakened or dismantled. So we entered the recent period of extreme financial instability with an

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approach to systemic risk that looked a lot like that of the period following the creation of the Federal Reserve Board but prior to the New Deal era. And so we saw the policy response to the initial phases of the current financial crisis primarily take the form of increasing liquidity into credit markets through interest rate reductions and increasingly liberal provision of credit to banks and then to non-bank financial institutions.

However, with the collapse of Lehman Brothers and the federal rescues of AIG, FNMA, and the FHLMC, the federal response to the perception of systemic risk turned toward much more aggressive interventions in an effort to ensure that after the collapse of Lehman Brothers, there would be no more defaults by large financial institutions. This approach was made somewhat more explicit with the passage of the Emergency Economic Stabilization Act of 2008 and the commencement of the TARP program. The reality was though that the TARP program was the creature of certain very broad passages in the bill, which generally was written with the view that the federal government would be embarking on the purchase of troubled assets, a very different approach than the direct infusions of equity capital that began with the Capital Purchase Program in October of 2008.

We can now learn some lessons from this experience for the management of systemic risk in the financial system.

First, our government and other governments around the world will step in when major financial institutions face bankruptcy. We do not live in a world of free market discipline when it comes to large financial institutions, and it seems unlikely we ever will. If two administrations as different as the Bush Administration and the Obama Administration agree that the federal government must act when major financial institutions fail, it is hard to imagine the

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administration that would do differently. Since the beginning of 2008, we have used federal dollars in various ways to rescue either the debt or the equity holders or both at the following companies—Bear Stearns, Indymac, Washington Mutual, AIG, Merrill Lynch, Fannie Mae, Freddie Mac, Citigroup and Bank of America. But we have no clear governmental entity charged with making the decision over which company to rescue and which to let fail, no clear criteria for how to make such decisions, and no clear set of tools to use in stabilizing those that must be stabilized.

Second, we appear to be hopelessly confused as to what it means to stabilize a troubled financial institution to avoid systemic harm. We have a longstanding system of protecting small depositors in FDIC insured banks, and by the way policyholders in insurance companies through the state guarantee funds. The FDIC has a process for dealing with banks that fail—a process that does not always result in 100% recoveries for uninsured creditors. Then we have the steps taken by the Treasury Department and the Federal Reserve since Bear Stearns collapsed. At some companies, like Fannie Mae and Freddie Mac, those steps have guaranteed all creditors, but wiped out the equity holders. At other companies, like Bear Stearns, AIG, and Wachovia, while the equity holders survive, they have been massively diluted one way or another. At others, like Citigroup and Bank of America, the equity has been only modestly diluted when looked at on an upside basis. It is hard to understand exactly what has happened with the government's interaction with Morgan Stanley and Goldman Sachs, but again there has been very little equity dilution. And then there is poor Lehman Brothers, apparently the only non-systemic financial institution, where everybody lost. In crafting a systematic approach to systemically significant institutions, we should begin with the understanding that while a given

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financial institution may be systemically significant, not every layer of its capital structure should be necessarily propped up with taxpayer funds.

Third, much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. Candidly, institutional investors have been able to participate in a number of relatively lightly regulated markets based on this idea. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. I do not mean to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Fourth, financial markets are global now. Norwegian villages invest in U.S. mortgage backed securities. British bankruptcy laws govern the fate of U.S. clients of Lehman Brothers, an institution that appeared to be a U.S. institution. AIG, our largest insurance company, collapsed because of a London office that employed 300 of AIG's 500,000 employees. Chinese industrial workers riot when U.S. real estate prices fall. We increasingly live in a world where the least common denominator in financial regulation rules.

So what lessons should we take away for how to manage systemic risk in our financial system?

The Congressional Oversight Panel, in its report to Congress made the following points about addressing systemic risk.

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1) There should be a body charged with monitoring sources of systemic risk in the financial system, but it could either be a new body, an existing agency, or a group of existing agencies;

2) The body charged with systemic risk managements should be fully accountable and transparent to the public in a manner that exceeds the general accountability mechanisms present in self-regulatory organizations;

3) We should not identify specific institutions in advance as too big to fail, but rather have a regulatory framework in which institutions have higher capital requirements and pay more on insurance funds on a percentage basis than smaller institutions which are less likely to be rescued as being too systemic to fail.

4) Systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets.

5) Ironically, effective protection against systemic risk requires that the shadow capital markets—institutions like hedge funds and products like credit derivatives—must not only be subject to systemic risk oriented oversight but must also be brought within a framework of routine capital market regulation by agencies like the Securities and Exchange Commisson.

6) There are some specific problems in the regulation of financial markets, such as the issue of the incentives built into executive compensation plans and the conflict of interest

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inherent in the credit rating agencies' business model of issuer pays, that need to be addressed to have a larger market environment where systemic risk is well managed.

7) Finally, there will not be effective reregulation of the financial markets without a global regulatory floor.

I would like to explain some of these principles and at least the thinking I brought to them. First, on the issue of a systemic risk monitor, while the Panel made no recommendation, I have come to believe that the best approach is a body made up of the key regulators. There are several reasons for this conclusion. First, this body must have as much access as possible to all information extant about the condition of the financial markets—including not just bank credit markets, but securities and commodities, and futures markets, and consumer credit markets. As long as we have the fragmented bank regulatory system we now have, this body would need access to information about the state of all deposit taking institutions. The reality of the interagency environment is that for information to flow freely, all the agencies involved need some level of involvement with the agency seeking the information. Connected with the information sharing issue is expertise. It is unlikely a systemic risk regulator would develop deep enough expertise on its own in all the possible relevant areas of financial activity. To be effective it would need to cooperate in the most serious way possible with all the routine regulators where the relevant expertise would be resident.

Second, this coordinating body must be fully public. While many have argued the need for this body to be fully public in the hope that would make for a more effective regulatory culture, the TARP experience highlights a much more bright line problem. An effective systemic risk regulator must have the power to bail out institutions, and the experience of the last year is that

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liquidity provision is simply not enough in a real crisis. An organization that has the power to expend public funds to rescue private institutions must be a public organization—though it should be insulated from politics much as our other financial regulatory bodies are by independent agency structures.

Here is where the question of the role of the Federal Reserve comes in. A number of commentators and Fed officials have pointed out that the Fed has to be involved in any body with rescue powers because any rescue would be mounted with the Fed's money. However, the TARP experience suggests this is a serious oversimplification. While the Fed can offer liquidity, many actual bailouts require equity infusions, which the Fed cannot currently make, nor should it be able to, as long as the Fed continues to seek to exist as a not entirely public institution. In particular, the very bank holding companies the Fed regulates are involved in the governance of the regional Federal Reserve Banks that are responsible for carrying out the regulatory mission of the Fed, and would if the current structure were untouched, be involved in deciding which member banks or bank holding companies would receive taxpayer funds in a crisis.

These considerations also point out the tensions that exist between the Board of Governors of the Federal Reserve System's role as central banker, and the great importance of distance from the political process, and the necessity of political accountability and oversight once a body is charged with dispersing the public's money to private companies that are in trouble. That function must be executed publicly, and with clear oversight, or else there will be inevitable suspicions of favoritism that will be harmful to the political underpinnings of any stabilization effort. One benefit of a more collective approach to systemic risk monitoring is that the Federal

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Reserve Board could participate in such a body while having to do much less restructuring that would likely be problematic in terms of its monetary policy activity.

On the issue of whether to identify and separately regulate systemically significant firms, another lesson of the last eighteen months is that the decision as to whether some or all of the investors and creditors of a financial firm must be rescued cannot be made in advance. In markets that are weak or panicked, a firm that was otherwise seen as not presenting a threat of systemic contagion might be seen as doing just that. Conversely, in a calm market environment, it maybe the better course of action to let a troubled firm go bankrupt even if it is fairly large. Identifying firms ex ante as systemically significant also makes the moral hazard problems much more intense.

An area the Congressional Oversight Panel did not address explicitly is whether effective systemic risk management in a world of diversified institutions would require some type of universal systemic risk insurance program or tax. Such a program would appear to be necessary to the extent the federal government is accepting it may be in a position of rescuing financial institutions in the future. Such a program would be necessary both to cover the costs of such interventions and to balance the moral hazard issues associated with systemic risk management. However, there are practical problems defining what such a program would look like, who would be covered and how to set premiums. One approach would be to use a financial transactions tax as an approximation. The global labor movement has indicated its interest in such a tax on a global basis, in part to help fund global reregulation of financial markets.

More broadly, these issues return us to the question of whether the dismantling of the approach to systemic risk embodied in the Glass-Steagall Act was a mistake. We would appear now to be in a position where we cannot wall off more risky activities from less risky liabilities like

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demand deposits or commercial paper that we wish to ensure. On the other hand, it seems mistaken to try and make large securities firms behave as if they were commercial banks. Those who want to maintain the current dominance of integrated bank holding companies in the securities business should have some burden of explaining how their securities businesses plan tc act now that they have an implicit government guaranty.

Finally, the AFL-CIO believes very strongly that the regulation of the shadow markets, and of the capital markets as a whole cannot be shoved into the category labeled "systemic risk regulation," and then have that category be effectively a sort of night watchman effort. The lesson of the failure of the Federal Reserve to use its consumer protection powers to address the rampant abuses in the mortgage industry earlier in this decade is just one of several examples going to the point that without effective routine regulation of financial markets, efforts to minimize the risk of further systemic breakdowns are unlikely to succeed. We even more particularly oppose this type of formulation that then hands responsibility in the area of systemic risk regulation over to self-regulatory bodies.

As Congress moves forward to address systemic risk management, one area that we believe deserves careful consideration is how much power to give to a body charged with systemic risk management to intervene in routine regulatory policies and practices. There are a range of options, ranging from power so broad it would amount to creating a single financial services superregulator, e.g. vesting such power in staff or a board chairman acting in an executive capacity, to arrangements requiring votes or supermajorities, to a system where the systemic risk regulator is more of scout than a real regulator, limited in its power to making recommendations to the larger regulatory community. The AFL-CIO would tend to favor a choice somewhere

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more in the middle of that continuum, but we think this is an area where further study might help policymakers formulate a well-founded approach.

Finally, with respect to the jurisdiction and the reach of a systemic risk regulator, we believe it must not be confined to institutions per se, or products or markets, but must extend to all financial activity.

In conclusion, the Congressional Oversight Panel's report lays out some basic principles that as a Panel member I hope will be of use to this Committee and to Congress in thinking through the challenges involved in rebuilding a more comprehensive approach to systemic risk. The AFL-CIO is very concerned that as Congress approaches the issue of systemic risk it does so in a way that bolsters a broader reregulation of our financial markets, and does not become an excuse for not engaging in that needed broader reregulation. Thank you.

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Congressional Oversight Panel

January 2009

SPECIAL REPORT ON REGULATORY REFORM

Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability*

*Submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

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CONGRESSIONAL OVERSIGHT PANEL

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Report Submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

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I. Executive Summary

1. Lessons from the Past

Financial crises are not new. As early as 1792, during the presidency of George Washington, the nation suffered a severe panic that froze credit and nearly brought the young economy to its knees. Over the next 140 years, financial crises struck on a regular basis—in 1797, 1819, 1837, 1857, 1873, 1893–96, 1907, and 1929–33—roughly every fifteen to twenty years.

But as the United States emerged from the Great Depression, something remarkable happened: the crises stopped. New financial regulation—including federal deposit insurance, securities regulation, and banking supervision—effectively protected the system from devastating outbreaks. Economic growth returned, but recurrent financial crises did not. In time, a financial crisis was seen as a ghost of the past.

After fifty years without a financial crisis—the longest such stretch in the nation's history—financial firms and policy makers began to see regulation as a barrier to efficient functioning of the capital markets rather than a necessary precondition for success.

This change in attitude had unfortunate consequences. As financial markets grew and globalized, often with breathtaking speed, the U.S. regulatory system could have benefited from smart changes. But deregulation and the growth of unregulated, parallel shadow markets were accompanied by the nearly unrestricted marketing of increasingly complex consumer financial products that multiplied risk at every stratum of the economy, from the family level to the global level. The result proved disastrous. The first warning followed deregulation of the thrifts, when the country suffered the savings and loan crisis in the 1980s. A second warning came in 1998 when a crisis was only narrowly averted following the failure of a large unregulated hedge fund. The near financial panic of 2002, brought on by corporate accounting and governance failures, sounded a third warning.

The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public.

2. Shortcomings of the Present

The current crisis should come as no surprise. The present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings.

Financial markets are inherently volatile and prone to extremes. The government has a critical role to play in helping to manage both public and private risk. Without clear and effective rules in place, productive financial activity can degenerate into unproductive gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to swindles and fraud.

A well-regulated financial system serves a key public purpose: if it has the power and if its leaders

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have the will to use that power, it channels savings and investment into productive economic activity and helps prevent financial contagion. Like the management of any complex hazard, financial regulation should not rely on a single magic bullet, but instead should employ an array of related measures for managing various elements of risk. The advent of the automobile brought enormous benefits but also considerable risks to drivers, passengers, and pedestrians. The solution was not to prohibit driving, but rather to manage the risks through reasonable speed limits, better road construction, safer sidewalks, required safety devices (seatbelts, airbags, children's car seats, antilock breaks), mandatory automobile insurance, and so on. The same holds true in the financial sector.

In recent years, however, the regulatory system not only failed to manage risk, it also failed to require disclosure of risk through sufficient transparency. American financial markets are profoundly dependent upon transparency. After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk.

Markets have become opaque in multiple ways. Some markets, such as hedge funds and credit default swaps, provide virtually no information. Even so, disclosure alone does not always provide genuine transparency. Market participants must have useful, relevant information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner. Mortgage documentation suffers from a similar problem, with reams of paper thrust at borrowers at closing, far too late for any borrower to make a well-informed decision. Just as markets and financial products evolve, so too must efforts to provide understanding through genuine transparency.

To compound the problem associated with uncontained and opaque risks, the current regulatory framework has failed to ensure fair dealings. Unfair dealing can be blatant, such as outright deception or fraud, but unfairness can also be much more subtle, as when parties are unfairly matched. Individuals have limited time and expertise to master complex financial dealings. If one party to a transaction has significantly more resources, time, sophistication or experience, other parties are at a fundamental disadvantage. The regulatory system should take appropriate steps to level the playing field.

Unfair dealings affect not only the specific transaction participants, but extend across entire markets, neighborhoods, socioeconomic groups, and whole industries. Even when only a limited number of families in one neighborhood have been the direct victims of a predatory lender, the entire neighborhood and even the larger community will suffer very real consequences from the resulting foreclosures. As those consequences spread, the entire financial system can be affected as well. More importantly, unfairness, or even the perception of unfairness, causes a loss of confidence in the marketplace. It becomes all the more critical for regulators to ensure fairness through meaningful disclosure, consumer protection measures, stronger enforcement, and other measures. Fair dealings provide credibility to businesses and satisfaction to consumers.

In tailoring regulatory responses to these and other problems, the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where

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the threats—especially the threats to other citizens—are greatest, and it should be more moderate elsewhere.

3. Recommendations for the Future

Modern financial regulation can provide consumers and investors with adequate information for making sound financial decisions and can protect them from being misled or defrauded, especially in complex financial transactions. Better regulation can reduce conflicts of interest and help manage moral hazard, particularly by limiting incentives for excessive risk taking stemming from often implicit government guaranties. By limiting risk taking in key parts of the financial sector, regulation can reduce systemic threats to the broader financial system and the economy as a whole. Ultimately, financial regulation embodies good risk management, transparency, and fairness.

Had regulators given adequate attention to even one of the three key areas of risk management, transparency and fairness, we might have averted the worst aspects of the current crisis.

1. Risk management should have been addressed through better oversight of systemic risks. If companies that are now deemed "too big to fail" had been better regulated, either to diminish their systemic impact or to curtail the risks they took, then these companies could have been allowed to fail or to reorganize without taxpayer bailouts. The creation of any new implicit government guarantee of high-risk business activities could have been avoided.
2. Transparency should have been addressed though better, more accurate credit ratings. If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.
3. Fairness should have been addressed though better regulation of consumer financial products. If the excesses in mortgage lending had been curbed by even the most minimal consumer protection laws, the loans that were fed into the mortgage backed securities would have been choked off at the source, and there would have been no "toxic assets" to threaten the global economy.

While the current crisis had many causes, it was not unforeseeable. Correcting the mistakes that fueled this crisis is within reach. The challenge now is to develop a new set of rules for a new financial system.

The Panel has identified eight specific areas most urgently in need of reform:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Increase supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.

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8. Plan for the next crisis.

While these are the most pressing reform recommendations, many other issues merit further study, the results of which the Panel will present in future reports. Despite the magnitude of the task, the central message is clear: through modernized regulation, we can dramatically reduce the risk of crises and swindles while preserving the key benefits of a vibrant financial system

Americans have paid dearly for this latest crisis. Lost jobs, failed businesses, foreclosed homes, and sharply cut retirement savings have touched people all across the county. Now every citizen—even the most prudent—is called on to assume trillions of dollars in liabilities spent to try to repair a broken system. The costs of regulatory failure and the urgency of regulatory reform could not be clearer.

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II. Introduction

The financial crisis that began to take hold in 2007 has exposed significant weaknesses in the nation's financial architecture and in the regulatory system designed to ensure its safety, stability, and performance. In fact, there can be no avoiding the conclusion that our regulatory system has failed.

The bursting of the housing bubble produced the first true stress test of modern capital markets, their instruments, and their participants. The first cracks were evident in the subprime mortgage market and in the secondary market for mortgage-related securities. From there, the crisis spread to nearly every corner of the financial sector, both at home and abroad, taking down some of the most venerable names in the investment banking and insurance businesses and crippling others, wreaking havoc in the credit markets, and brutalizing equity markets worldwide.

As asset prices deflated, so too did the theory that had increasingly guided American financial regulation over the previous three decades—namely, that private markets and private financial institutions could largely be trusted to regulate themselves. The crisis suggested otherwise, particularly since several of the least regulated parts of the system were among the first to run into trouble. As former Federal Reserve Chairman Alan Greenspan acknowledged in testimony before the House Committee on Oversight and Government Reform in October 2008, "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."[1]

The financial meltdown necessitates a thorough review of our regulatory infrastructure, the behavior of regulators and their agencies, and the regulatory philosophy that informed their decisions. At the same time, we must be careful to avoid the trap of looking solely backward—preparing to fight the last war. Although the crisis has exposed many deficiencies, there are likely others that have yet to be uncovered. What is more, the vast federal response to the crisis—including unprecedented rescues of crippled businesses and a proliferation of government guaranties—threatens to distort private incentives in the future, further eroding the caution of financial creditors and making the job of regulatory oversight all the more essential.

Realizing that far-reaching reform will be needed in the wake of the crisis, Congress directed the Congressional Oversight Panel (hereinafter "the Panel") to submit a special report on regulatory reform,

> analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the

[1] *See* Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, New York Times (Oct. 24, 2008). *See also* House Committee on Oversight and Government Reform, Testimony of Alan Greenspan, *The Financial Crisis and the Role of Federal Regulators*, 110th Cong., at 2 (Oct. 23, 2008) (online at oversight.house.gov/documents/20081023100438.pdf).

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rationale underlying such recommendation, and whether there are any gaps in existing consumer protections.[2]

Toward this end, part III of this report presents a broad framework for analyzing the effectiveness of financial regulation, focusing on three critical failures of the current system: (1) inadequate private and public risk management, (2) insufficient transparency and information, and (3) a lack of protection against deception and unfair dealing. These key failures of the regulatory system have manifested themselves in a plethora of more specific problems, ranging from excessively leveraged financial institutions to opaque financial instruments falling outside the scope of the jurisdiction of any regulatory agency. While this report cannot tackle every one of these problems, part IV focuses on eight areas of the current financial regulatory system that are in need of improvement, offering the Panel's recommendations for each as follows:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Modernize supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.

Finally, part V of this report points to some additional challenges in need of attention over the longer term, several of which will be addressed in future reports of the Panel. An appendix comprising summaries of other recent reports regarding reform of the regulatory system is found at the end of the report.

This report is motivated by the knowledge that millions of Americans suffer when the financial regulatory system and the capital markets fail. The financial meltdown has many causes but one overwhelming result: a great increase in unexpected hardships and financial challenges for American citizens. The unemployment rate is rising sharply every month, a growing number of Americans are facing the prospect of losing their homes, retirees are worried about how to afford even basic necessities, and families are anxious about paying for college and securing a decent start in adult life. The goal of the regulatory reforms presented in this report is not to endorse a particular economic theory or merely to guide the country through the current crisis. The goal is instead to establish a sturdy regulatory system that will facilitate the growth of financial markets and will protect the lives of current and future generations of Americans.

[2] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, at § 125(b)(2).

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III. A Framework for Analyzing the Financial Regulatory System and its Effectiveness

1. The Promise and Perils of Financial Markets

Households, firms, and government agencies all rely on the financial system for saving and raising capital, settling payments, and managing risk. A dynamic financial system facilitates the mobilization of resources for large projects and the transfer of resources across time and space and provides critical information in the form of price signals that help to coordinate dispersed economic activity. A healthy financial system, one that allows for the efficient allocation of capital and risk, is indispensable to any successful economy.

Unfortunately, financial systems are also prone to instability and abuse. Until the dawn of modern financial regulation in the 1930s and early 1940s, financial panics were a regular—and often debilitating—feature of American life. The United States suffered significant financial crises in 1792, 1819, 1837–39, 1857, 1873, 1893–95, 1907, and 1929–33. After the Great Depression and the introduction of federal deposit insurance and federal banking and securities regulation, the next significant banking crisis did not strike for more than forty years. This period of relative stability—by far the longest in the nation's history—persisted until the mid-1980s, with the onset of the savings and loan crisis; dealing with that crisis cost American taxpayers directly some $132 billion.[3] The country also suffered a group of bank failures that produced the need to recapitalize the FDIC's initial Bank Insurance Fund in the early 1990s; suffered a stock market crash in 1987; witnessed a wave of foreign currency crises (and associated instability) in 1994–95 and 1997–98; saw the collapse of Long Term Capital Management (LCTM) hedge fund in 1998; and faced the collapse of the tech bubble in 2001. Financial crisis has now struck again, with the subprime-induced financial turmoil of 2007–09.

Although every crisis is distinctive in its particulars, the commonalities across crises are often more striking than the differences. As the financial historian Robert Wright explains: "All major panics follow the same basic outline: asset bubble, massive leverage (borrowing to buy the rising asset), bursting bubble (asset price declines rapidly), defaults on loans, asymmetric information and uncertainty, reduced lending, declining economic activity, unemployment, more defaults."[4]

Nor are financial panics the only cause for concern. Financial markets have also long exhibited a vulnerability to manipulation, swindles, and fraud, including William Duer's notorious attempt to corner the market for United States government bonds in 1791–92, the "wildcat" life insurance companies of the early nineteenth century (which took premiums from customers but disappeared before paying any claims), the infamous pyramiding scheme of Charles Ponzi in 1920, and the highly suspect practices of New York's National City Bank and its chairman, Charles Mitchell, in

[3] On the period of relative financial stability ("the great pause"), *see* David Moss, *An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System* (2009). *See also* Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s*, at 187 (online at www.fdic.gov/bank/historical/history/167_188.pdf).

[4] *See* Andrea Young, *What Economic Historians Think About the Meltdown*, History News Network (Oct. 20, 2008) (online at hnn.us/articles/55851.html).

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the run-up to the Great Crash of 1929. The apparent massive Ponzi scheme of Bernard Madoff that has recently unraveled in 2008 is only the latest in a long series of such financial scandals.

Even apart from the most spectacular financial crises and crimes, the failure of any individual financial institution—all by itself—can have devastating consequences for the investors and clients who rely on it.[5] The collapse of a bank, insurance company, or pension fund can prove particularly damaging, disrupting longstanding financial relationships and potentially destroying the safety nets that many Americans have spent years carefully building.

The good news is that many of these financial risks can be significantly attenuated through sound regulation. Well-designed regulation has the potential to enhance both financial safety and economic performance, and it has done so in the past. To be sure, the risks of capital market crises cannot be eliminated altogether, just as the risk of automobile accidents will never entirely disappear, despite rigorous safety standards.

2. The Current State of the Regulatory System

The purpose of financial regulation is to make financial markets work better and to ensure that they serve the interests of all Americans. There are many important (and sometimes competing) goals of financial regulation, ranging from safety and stability to innovation and growth. In order to achieve these goals, an effective regulatory system must manage risk, facilitate transparency, and promote fair dealings among market actors. The current system has failed on all three counts.

Failure to Effectively Manage Risk

As the current financial meltdown makes clear, private financial markets do not always manage risk effectively on their own. In fact, to a large extent, the current crisis can be understood as the product of a profound failure in private risk management, combined with an equally profound failure in public risk management, particularly at the federal level.

Failure of private risk management. The risk-management lapses in the private sector are by now obvious. In the subprime market, brokers and originators often devoted relatively little attention to risk assessment, exhibiting a willingness to issue extraordinarily risky mortgages (for high fees) so long as the mortgages could be sold quickly on the secondary market.[6] Securitizers on Wall Street and elsewhere proved hungry for these high-interest-rate loans, because they could earn large fees for bundling them, dividing the payments into tranches, and selling the resulting securities to

[5] In fact, because of the salutary effects of existing regulations, not all failures of financial institutions create the same level of damage. For instance, the government has insured consumer deposits in financial institutions since the New Deal in recognition of the dangers of a loss of depositor confidence. Consequently, it is no longer the risk of shareholder losses that cause fear of systemic crisis, but rather the risk of financial institutions defaulting on fixed obligations.

[6] These mortgages included so-called 2-28s (which were scheduled to reset to a sharply higher interest rate after two years) and option-arms (which allowed customers essentially to set their own payments in an initial period, followed by ballooning payments after that). Whether or not borrowers could reasonably be expected to repay—based on their earning capacity—was no longer always a decisive criterion for lending, particularly against the backdrop of rising home prices. Said one broker of an elderly client who had lost his home as a result of an unaffordable loan, "It's clear he was living beyond his means, and he might not be able to afford this loan. But legally, we don't have a responsibility to tell him this probably isn't going to work out. It's not our obligation to tell them how they should live their lives." *See* Charles Duhigg, *When Shielding Money Clashes with Elders' Free Will*, New York Times (Dec 24, 2007).

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investors. These securities proved attractive, even to relatively risk-averse investors, because the credit rating agencies (who were paid by the issuers) awarded their triple-A seal of approval to the vast majority of the securities in any given issue. The credit rating agencies concluded—wrongly, it turns out—that virtually all of the risk of a subprime mortgage-backed securitization was concentrated in its lowest tranches (e.g., the bottom 15 to 25 percent) and that the remainder was exceedingly safe. Nor did the process end there, since lower-tranche securities (e.g., those with a BBB rating or below) could be aggregated into so-called collateralized debt obligations (CDOs) and re-tranched, creating whole new sets of AAA and AA securities. Only when the housing market turned down and delinquencies and foreclosures started to rise, beginning in 2006–07, did the issuers, investors, and rating agencies finally recognize how severely they had underestimated the key risks involved.[7]

Had these excesses been limited to the subprime market, it is unlikely that the initial turmoil could have sparked a full-blown financial crisis. Unfortunately, the broader financial system was in no position to absorb the losses because a great many of the leading financial firms were themselves heavily leveraged (especially by incurring a large proportion of short-term debt) and contingent liabilities (including many tied back to the housing market). Such leverage had greatly magnified returns in good times, but proved devastating once key assets began to drop in value. Higher-leverage necessarily meant higher risk. As it became clear that not only AAA-rated mortgage-backed securities but also AAA-rated financial institutions were at risk, trust all but disappeared in the marketplace, leaving even potentially solvent financial institutions vulnerable to runs by their creditors, who were rattled and increasingly operating on a hair trigger.[8]

In a sense, no one should have been surprised by the turmoil. Unregulated and weakly regulated financial markets have historically shown a tendency toward excessive risk taking and instability. The reasons for this are worth reviewing.

To begin with, financial actors do not always bear the full consequences of their decisions and therefore are liable to take (or impose) more risk than would otherwise seem reasonable. For example, financial institutions generally invest other people's money and often enjoy asymmetric compensation incentives, which reward them for gains without penalizing them for losses. Even more troubling, the failure of a large financial firm can have systemic consequences, potentially triggering a cascade of losses, which means that risk taking by the firm can impose costs far beyond its own shareholders, creditors, and counterparties. The freezing up of the credit markets in 2008–09, because even healthy banks are afraid to lend, is an especially serious example of this phenomenon.

A closely related problem is that of contagion or panic, in which fear drives a sudden surge in demand for safety and liquidity. A traditional bank run by depositors is one expression of contagion, but other types of creditors can also create a "run" on a financial institution and potentially weaken or destroy it; for example, short-term lenders can refuse to roll over existing loans to the institution, and market actors may refuse to continue to deal with it. In fact, whole markets can succumb to

[7] Credit card and automobile loans are also securitized and sold in various formats. It remains to be seen whether an increased rate of default on those loans (which can be expected as the economic slowdown deepens) will generate a second wave of severe capital market disruptions.

[8] *See* section III.2.

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panic selling under certain circumstances. In all of these cases, the fearful depositors, creditors, and investors who suddenly decide to liquidate their positions may be imposing costs on others, since the first to run will generally get their money out whereas the last to do so typically will not. More broadly, poorly managed financial institutions impose costs on well-managed ones, because of the threat of contagion.

Yet another problem endemic to financial markets is that individual borrowers and investors may not always be ideally positioned to evaluate complex risks. How can any of us be sure that a particular financial agreement or product is safe? Ideally, we carefully read the contract or prospectus. But given limits on time and expertise (including the expense of expert advice), even a relatively careful consumer or investor is liable to make mistakes—and potentially large ones—from time to time. Virtually all of us, moreover, rely on various kinds of shortcuts in assessing risks in daily life—intuition, seeking nonexpert outside advice, a trusting attitude toward authority, and so on. Although such an approach may normally work well, it sometimes fails and is particularly subject to manipulation—for example, by aggressive (or even predatory) lenders. Such problems were an important contributor to the excesses and eventual implosion of subprime mortgage lending. In addition, particularly in recent years, it appears that even many of the most sophisticated investors—and perhaps even the credit rating agencies themselves—had trouble assessing the risks associated with a wide array of new and complex financial instruments. Complexity itself may therefore have contributed to the binge of risk taking that overtook the United States financial system in recent years.

Failure of public risk management. Ideally, state and federal regulators should have intervened to control the worst financial excesses and abuses long before the crisis took hold. Almost everyone now recognizes that the government serves as the nation's ultimate risk manager—as the lender, insurer, and spender of last resort—in times of crisis. But effective public risk management is critical in normal times as well, both to protect consumers and investors and to help prevent crises from developing in the first place.[9]

A good example involves bank regulation. Americans have faced recurrent banking crises as well as frequent bank suspensions and failures for much of the nation's history. The problem appeared to ease after the creation of the Federal Reserve in 1914 but then returned with a vengeance in 1930–33, when a spiraling panic nearly consumed the entire American banking system. All of this changed after the introduction of federal deposit insurance in June of 1933. Bank runs virtually disappeared, and bank failures fell sharply. Critics worried that the existence of federal insurance would encourage excessive risk taking (moral hazard), because depositors would no longer have to worry about the soundness of their banks and instead would be attracted by the higher interest rates that riskier banks offered. The authors of the 1933 legislation prepared for this threat, authorizing not only public deposit insurance but also intelligent bank regulation designed to ensure the safety and soundness of insured banks. The end result was an effective system of new consumer protections, a remarkable reduction in systemic risk, and a notable increase in public confidence in the financial system. By all indications, well-designed government risk management helped

[9] On the government's role as a risk manager, *see* David Moss, *When All Else Fails: Government as the Ultimate Risk Manager* (2002).

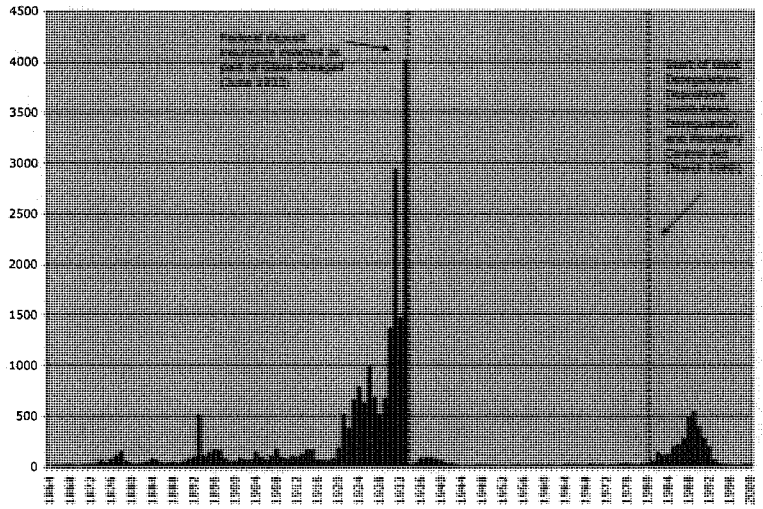
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strengthen the market and prevent subsequent crises.[10] (See figure below: Bank Failures, 1864–2000).

A Unique Period of Calm Amid the Storm: Bank Failures (Suspensions), 1864–2000



Source: David Moss, "An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System," 2009.

In our own time, appropriate regulatory measures might have proved similarly salutary. Reasonable controls on overly risky consumer and corporate lending and effective limits on the leverage of major (systemic) financial institutions might have been enough, by themselves, to prevent the worst aspects of the collapse. Greater regulatory attention in numerous other areas, from money market funds and credit rating agencies to credit default swaps, might also have made a positive difference. However, key policymakers, particularly at the federal level, often chose not to expand this critical risk-management role—to cover new and emerging risks—when they had the chance.

Looking forward, the need for meaningful regulatory reform has now become particularly urgent—not only to correct past mistakes, but also to limit the likelihood and the impact of future crises and to control the moral hazard that is likely to flow from the recent profusion of federal bailouts and guaranties. If creditors, employees, and even shareholders of major financial institutions conclude that the federal government is likely to step in again in case of trouble (because of the systemic significance of their institutions), they may become even more lax about monitoring risk, leading to even greater excesses in the future. For this reason, the recent federal actions in support of the

[10] In fact, significant bank failures did not reappear until after the start of bank deregulation in the early 1980s. Bank deregulation is often said to have started with the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, and the Depository Institutions Act of 1982, Pub. L. No. 97-320.

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nation's largest financial institutions, involving more than $10 trillion in new federal guaranties, make effective regulation after the crisis even more vital. The example set in 1933—of pairing explicit public insurance with an effective regulatory mechanism for monitoring and controlling moral hazard—must not be forgotten. In fact, the need to control the moral hazard created by the current financial rescue may be the most important reason of all for strengthening financial regulation in the months and years ahead.

Failure to Require Sufficient Transparency

While allowing financial institutions to take on too much risk, federal and state regulators at the same time have permitted these actors to provide too little information to protect investors and enable markets to function honestly and efficiently. Because financial information often represents a public good, it may not be adequately provided in the marketplace without government encouragement or mandate. Investors without access to basic financial reporting face serious information asymmetries, potentially raising the cost of capital and compromising the efficient allocation of financial resources.[11] Truthful disclosures are also essential to protect investors. Essential disclosure and reporting requirements may therefore enhance efficiency by reducing these informational asymmetries. The broad availability of financial information also promises to boost public confidence in financial markets. As former Securities and Exchange Commssion (SEC) Chairman Arthur Levitt has observed, "the success of capital is directly dependent on the quality of accounting and disclosure systems. Disclosure systems that are founded on high-quality standards give investors confidence in the credibility of financial reporting—and without investor confidence, markets cannot thrive."[12]

From the time they were introduced at the federal level in the early 1930s, disclosure and reporting requirements have constituted a defining feature of American securities regulation (and of American financial regulation more generally). President Franklin Roosevelt himself explained in April 1933 that although the federal government should never be seen as endorsing or promoting a private security, there was "an obligation upon us to insist that every issue of new securities to be sold in interstate commerce be accompanied by full publicity and information and that no essentially important element attending the issue shall be concealed from the buying public."[13]

Historically, embedding a flexible approach to jurisdiction has made for strong, effective regulatory agencies. When the SEC was founded, during the Depression, Congress armed the commission with statutory authority based upon an extremely broad view of what constituted a security and gave it wide latitude in determining what disclosures were necessary from those who sought to sell securities to the public. There was a similar breadth of coverage and

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[11] Modern economic research has shown that markets can only function efficiently—that Adam Smith's "invisible hand" only works—to the extent that the information processed by the markets is accurate and complete. *See* Joseph E. Stiglitz, *Globalization and Its Discontents* (2002) at ch. 3, n. 2 and accompanying text. On information asymmetry and the cost of capital, *see* Douglas Diamond and Robert Verrecchia, *Disclosure, Liquidity, and the Cost of Capital*, Journal of Finance, at 1325–1359 (Sept. 1991). *See also* S. P. Kothari, *The Role of Financial Reporting in Reducing Financial Risks in the Market, in Building and Infrastructure for Financial Stability,* at 89–102 (Eric. S. Rosengren and John S. Jordon eds., June 2000).

[12] *See id.* at 91.

[13] *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, George Washington Law Review, at 30 (1959).

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flexibility in substantive approach in the Investment Advisors Act and the Investment Company Act, which together governed money managers. These broad grants of jurisdiction led to the SEC's having regulatory authority over most capital-market transactions outside the banking and insurance systems until the end of the 1970s.

However, the financial markets have outpaced even the broadest grants of regulatory authority. Starting in the 1980s, skilled market operators began to exploit what had previously seemed to be merely insignificant loopholes in this system—exceptions that had always existed in the regulation of investment management. The increasing importance of institutional intermediaries in the capital markets exacerbated this tendency. By the 1990s, the growth of over-the-counter derivative markets had created unregulated parallel capital-market products. This trend has continued in recent years, with the SEC allowing the founding of publicly traded hedge-fund and private-equity management firms that do not have to register as investment companies.

Over subsequent years, the reach of the SEC and its reporting requirements were gradually expanded. Securities traded over the counter, for example, were brought into the fold beginning in 1964. The SEC targeted "selective disclosure" in 2000 with Regulation Fair Disclosure (Reg FD), a new weapon in the ongoing fight against insider activities. Two years later, Congress passed the Sarbanes-Oxley Act, which aimed to bolster the independence of the accounting industry and required top corporate executives to personally certify key financial statements.[14]

By the time the crisis struck in 2007–08, however, one of the most common words used to describe the American financial system was "opaque." Hedge funds, which squeeze into an exemption in the Investment Company Act of 1940, face almost no registration or reporting requirements; moreover, a modest attempt by the SEC to change this situation was struck down in federal court in 2006. Similarly, over-the-counter markets for credit default swaps and other derivative instruments remain largely unregulated and, say critics, constitute virtually the polar opposite of open and transparent exchange. (According to news reports, an attempt by Brooksley Born, the former chairperson of the Commodity Futures Trading Commission, to regulate OTC-traded derivatives in 1997–98, was blocked by Fed Chairman Alan Greenspan, Treasury Secretary Robert Rubin, and others, allegedly on the grounds that such regulation could precipitate a financial crisis. In any event, Congress in 2000 prohibited regulation of most derivatives.)[15] In addition, the proliferation of off-balance-sheet entities (conduits, structured investment vehicles [SIVs], etc.) and the rapid growth of highly complex financial instruments (such as CDOs) further undermined clarity and understanding in the marketplace. The financial consultant Henry Kaufman maintains that leading financial institutions actively "pushed legal structures that made many aspects of the financial markets opaque."[16] Moreover, starting in 1994, with the Central Bank of Denver decision,[17] the courts have severely

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[14] *See* Chris Yenkey, *Transparency, Democracy, and the SEC: 70 Years of Securities Market Regulation, in Transparency in a New Global Order: Unvailing Organizational Visions* (Christina Garsten and Monica Lindh de Montoya eds., 2007).

[15] Peter S. Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy*, New York Times (Oct. 8, 2008).

[16] Henry Kaufman, *How the Credit Crisis Will Change the Way America Does Business: Huge Financial Companies Will Grow at the Expense of Borrowers and Investors*, Wall Street Journal (Dec. 6, 2008).

[17] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

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limited the ability of investors to police transparency failures involving financial institutions working with public companies. This failure was extended in the Supreme Court's Stoneridge decision,[18] closing off liability to investors even in cases in which financial institutions were participants in a fraudulent scheme.

There are of course legitimate questions about how far policymakers should go in requiring disclosure—where the line should be drawn between public and proprietary information. But particularly given the breakdown that has now occurred, it is difficult to escape the conclusion that America's financial markets have veered far from the goal of transparency, fundamentally compromising the health and vitality of the financial sector and, ultimately, the whole economy.

Why our regulatory system failed to expand the zone of transparency in the face of far-reaching financial innovation is a question that merits careful attention. At least part of the answer, once again, appears to be that key regulators preferred not to expand the regulatory system to address these challenges, or simply believed that such expansion was unnecessary. In 2002, for example, Federal Reserve Chairman Alan Greenspan explained his view on "the issue of regulation and disclosure in the over-the-counter derivatives market" this way:

> By design, this market, presumed to involve dealings among sophisticated professionals, has been largely exempt from government regulation. In part, this exemption reflects the view that professionals do not require the investor protections commonly afforded to markets in which retail investors participate. But regulation is not only unnecessary in these markets, it is potentially damaging, because regulation presupposes disclosure and forced disclosure of proprietary information can undercut innovations in financial markets just as it would in real estate markets.[19]

Subsequent developments—including the effective failure (and rescue) of American International Group, Inc. (AIG), as a result of massive exposure in the credit default swaps market—raise serious questions about this hands-off view. The abuses in the mortgage markets, and especially in the subprime mortgage market, are a good example, but so are abuses throughout the range of consumer credit products. The challenge now is to develop a plan not only to bring much-needed sunlight into the most opaque corners of the financial system but to ensure appropriate regulatory adaptation to new financial innovation in the future.

Failure to Ensure Fair Dealings

The current regulatory system has not only allowed for excessive risk and an insufficient degree of transparency, but it has also failed to prevent the emergence of unfair dealings between actors. Overt lies are dishonest, of course, and lying may trigger legal liability. But fair dealing involves more than refraining from outright lying. Deception and misdirection are the antithesis of fair dealing. When the legal system permits deception and misdirection it undermines consensual

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[18] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008). *See also* Congressional Oversight Panel, Testimony of Joel Seligman, *Reforming America's Financial Regulatory Structure*, at 5 (Jan. 14, 2009) (online at cop.senate.gov/documents/testimony-011409-seligman.pdf).

[19] The Federal Reserve Board, *Remarks by Chairman Alan Greenspan before the Society of Business Economists, London, U.K.* (Sept. 25, 2002) (online at www.federalreserve.gov/BoardDocs/Speeches/2002/200209252/default.htm).

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agreements between parties, the very foundation of a market economy designed to serve all individuals.

Deceptive or misleading dealings can occur in any setting, but they are most likely to occur when the players are mismatched. When one player is sophisticated, has ample resources, and works regularly in the field while the other is a nonspecialist with limited resources and little experience, the potential for deception is at its highest. A credit card contract, for example, may be a relatively simple, straightforward agreement from which both issuer and customer may benefit. Or it may be a thirty-plus page document that is virtually incomprehensible to the customer. In the latter case, the issuer who can hire a team of lawyers to draft the most favorable language may carefully measure every nuance of the transaction, while the customer who has little time or sufficient expertise to read—much less negotiate—such a contract is far less likely to appreciate the risks associated with the deal.

Similarly, in the subprime mortgage market prospective borrowers were often led to believe that a scheduled interest-rate reset would never affect them because they had been told that they could "always" refinance the property at a lower rate before the reset took effect. Similarly, studies show that payday loan customers, while generally aware of finance charges, are often unaware of annual percentage rates.[20] In one survey, of those who took on tax refund anticipation loans, approximately half of all respondents were not aware of the substantial fees charged by the lender.[21] One authority on consumer credit has catalogued a long list of "tricks and traps," particularly in the credit card market, designed to "catch consumers who stumble or mistake those traps for treasure and find themselves caught in a snare from which they cannot escape."[22] While each of these contracts may meet the letter of the law, deals that are structured so that one side repeatedly does not understand the terms do not meet the definition of fair dealing.

The available evidence suggests that the costs of deceptive financial products are high, quickly climbing into the billions of dollars annually.[23] But the problem is not limited to monetary loss—many people are stripped not only of their wealth, but also of their confidence in the financial marketplace. They come to regard all financial products with suspicion, including those on fair terms and those that could be beneficial to them.

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[20] *See* NFI, Gregory Elliehausen, *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?*, at 29 (2006) (Working Paper No. 2006-WP-02); Credit Research Center, Georgetown University, Gregory Elliehausen and Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand*, at 2 (2001) (online at www.cfsa.net/downloads/analysis_customer_demand.pdf).

[21] *See* Elliehausen, *supra* note 20, at 31.

[22] Senate Committee on Banking, Housing and Urban Affairs of the United States Senate, Testimony of Elizabeth Warren, *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers*, 110th Cong., at 1 (Jan. 25, 2007) (online at banking.senate.gov/public/_files/warren.pdf). The list of tricks and traps includes "universal default, default rates of interest, late fees, over-limit fees, fees for payment by telephone, repeated changes in the dates bills are due, changes in the locations to which bills should be mailed, making it hard to find the total amount due on the bill, moving bill-reception centers to lengthen the time it takes a bill to arrive by mail, misleading customers about grace periods, and double cycle billing." *Id.* at 3.

[23] Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, University of Pennsylvania Law Review (Nov. 2008) (summarizing studies showing the high costs of consumer errors on checking accounts, credit cards, payday loans and refund anticipation loans).

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As the recent crisis has shown, the effects of deceptive contracts can have wide ripple effects. For example, deceptive mortgages have led to lender foreclosures on residential housing—foreclosures that cost taxpayers money and threaten the economic stability of already imperiled neighborhoods.[24] A recent housing report observed: "Foreclosures are costly—not only to homeowners, but also to a wide variety of stakeholders, including mortgage servicers, local governments and neighboring homeowners . . . up to $80,000 for all stakeholders combined."[25] Lenders can lose as well, forfeiting as much as $50,000 per foreclosure, which translates to roughly $25 billion in total foreclosure-related losses in 2003.[26] A city can lose up to $19,227 per house abandoned in foreclosure in lost property taxes, unpaid utility bills, property upkeep, sewage, and maintenance.[27] Many foreclosure-related costs fall on taxpayers, who ultimately must shoulder the bill for services provided by their local governments.

The burdens of credit-market imperfections are not spread evenly across economic, educational, or racial groups. The wealthy tend to be insulated from many credit traps, while the vulnerability of the working class and middle-class increases. For those closer to the economic margins, a single economic mistake—a credit card with an interest rate that unexpectedly escalates to 29.99 percent or misplaced trust in a broker who recommends a high-priced mortgage—can trigger a downward economic spiral from which no recovery is possible. There is ample evidence that African Americans and Hispanics have been targets for certain deceptive products, much to their injury and to the injury of a country that prizes equality of opportunity for all its citizens.[28]

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[24] *See* Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, at 15–16 (Apr. 2007) (online at jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=8c3884e5-2641-4228-af85-b61f8a677c28) (hereinafter "JEC Report"). *See also* Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, New York Times (Sept. 2, 2007) (online at www.nytimes.com/2007/09/02/business/yourmoney/02village.html); U.S. Department of the Treasury, *Remarks by Secretary Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments at Georgetown University Law Center* (Oct. 16, 2007) (online at www.treasury.gov/press/releases/hp612.htm) ("Foreclosures are costly and painful for homeowners. They are also costly for mortgage servicers and investors. They can have spillover effects into property values throughout a neighborhood, creating a downward cycle we must work to avoid.").

[25] JEC Report, *supra* note 24, at 17. *See also* Dan Immergluck and Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, Housing Policy Debate, at 69–72 (2006) (finding that a single-family home foreclosure causes a decrease in values of homes within an eighth of a mile—or one city block—by an average of 0.9 percent, or approximately $1,870 when the average home sale price is $164,599, and 1.44 percent in low- and moderate-income communities, or about $1,600 when the average home sale price is $111,002).

[26] *See, e.g.,* Desiree Hatcher, *Foreclosure Alternatives: A Case for Preserving Homeownership*, Profitwise News and Views, at 2 (Feb. 2006) (online at www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf).

[27] *See* JEC Report, *supra* note 24, at 15.

[28] *See, e.g.,* Consumer Federation of America, Allan J. Fishbein and Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, at 24 (May 2006) (online at www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf); U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, *Curbing Predatory Home Mortgage Lending*, at 35 (2000) (online at www.huduser.org/publications/hsgfin/curbing.html); Center for Community Change, Bradford Calvin, *Risk or Race? Racial Disparities and the Subprime Refinance Market*, at 6–8 (May 2002) (online at butera-andrews.com/legislative-updates/directory/Background-Reports/Center%20for%20Community%20Change%20Report.pdf); Paul Calem, Kevin Gillen and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, Journal of Real Estate Finance and Economics, at 401–404 (Dec. 2004). Another study, based on the Federal Reserve data, found that "African-

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When businesses sell deceptive products, they not only injure their customers but also injure their competitors, who are forced to adopt similar practices or face losing their markets. The result is a downward spiral, a race to the bottom in which those who offer the most slyly deceptive products enjoy the greatest profits while entire industries and markets are corrupted and cease to provide efficient and mutually beneficial transactions. The same phenomenon operates on a more macroeconomic level: some investment banks that may have had initial doubts about packing subprime loans were drawn into a downward spiral, abandoning their standards of investment quality in a race for the same profits that other firms appeared to be making.

Assuring fair dealing is not the same as assuring that no one makes a mistake. Buyers and sellers of financial services can miscalculate. They can fail to save, take unwise gambles, or simply buy too much. Personal responsibility will always play a critical role in dealing with financial products, just as personal responsibility remains essential to the responsible use of any physical product. Fair dealing assures only that deception and misdirection will not bring a person to ruin, while it leaves room to maximize the opportunities for people to chart their own economic futures, free to succeed and free to fail.

The government can play a unique role in assuring that repeat dealings in circumstances of substantial imbalances of power and knowledge are nonetheless fair dealings. Regulation can assure a more level playing field, one in which the terms of an agreement, for example, are clear and easily understood. When terms are clear, individuals are more likely to compare options, which in turn drives far greater market efficiency. More importantly, when terms are clear, individuals are better able to assess investment risks and are thus empowered to make decisions that are more beneficial for themselves.

By limiting the opportunities for deception and allowing for the necessary trust to develop between interconnected parties, regulation can enhance the vitality of financial markets. Historically, new regulation has often served this role. For example, as the money manager Martin Whitman has observed, far from stifling the markets, the new regulations of the Investment Company Act of 1940 enabled the targeted industry to flourish:

> It ill behooves any successful money manager in the mutual fund industry to condemn the very strict regulation embodied in the Investment Company Act of 1940. Without strict regulation, I doubt that our industry could have grown as it has grown, and also be as prosperous as it is for money managers. Because of the existence of strict regulation, the outside investor knows that money managers can

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American and Latino borrowers are at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors." Center for Responsible Lending, Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, at 3 (May 31, 2006) (online at www.responsiblelending.org/pdfs/rr011exec-Unfair_Lending-0506.pdf). A third study by the Survey Research Center at the University of Michigan found that black homeowners are significantly more likely to have prepayment penalties or balloon payments attached to their mortgages than nonblack homeowners, even after controlling for age, income, gender, and creditworthiness. Michael S. Barr, Jane K. Dokko, and Benjamin J. Keys, *Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low- and Moderate-Income Neighborhoods* (Apr. 2008) (online at ssrn.com/abstract=1121215). And a fourth study, by Susan Woodward, found that black borrowers pay an additional $415 in mortgage fees and Latino borrowers pay an additional $365 in mortgage fees. Urban Institute, Susan Woodward, *A Study of Closing Costs for FHA Mortgages*, at ix (2008).

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> be trusted. Without that trust, the industry likely would not have grown the way it has grown.[29]

Markets built on fair dealing produce benefits for all Americans on both sides of the transactions.

3. The Central Importance of Regulatory Philosophy

The magnitude of the current financial crisis makes clear that America's system of financial regulation has failed. As a result, there is now growing interest in reforming the essential structure of financial regulation in the United States. (See the appendix for a summary of other recent reports on regulatory reform.) Critics highlight the inherent problems of vesting regulatory authority in a large number of separate agencies at both the state and federal levels, each responsible for isolated elements of a vast financial architecture. Although this complex regulatory system benefits from competition across governmental bodies, it also suffers from the problem of "regulatory arbitrage" (a situation in which regulated firms play regulators off against one another) as well as numerous gaps in coverage.

Structural and organizational problems are certainly important, and are taken up in section III, below. But at root, the regulatory failure that gave rise to the current crisis was one of philosophy more than structure. In too many cases, regulators had the tools but failed to use them. And where tools were missing, regulators too often failed to ask for the necessary authority to develop what was needed.

Markets are powerful and robust institutions, and a healthy respect for free market activity has served this nation well since its founding. At the same time, the best tradition in American policy has always been pragmatic. History has consistently shown that markets cannot be counted upon to regulate themselves or to function efficiently in the absence of regulation. While the price mechanism calibrates supply and demand, it cannot prevent bank runs, abusive lending or Ponzi schemes without regulation. The current financial meltdown proves these points in an especially severe way.

Excesses and abuse are all too common in a system without regulation. Government thus has a vital role to play. As President Lincoln once wrote: "The legitimate object of government, is to do for a community of people, whatever they need to have done, but can not do, *at all*, or can not, *so well do*, for themselves—in their separate, and individual capacities."[30]

Lincoln's vision of government goes beyond correcting abuses to improving the welfare of "a community of people." Regulators must never lose sight of the fact that the well-being of Americans is their goal, and that the welfare of the people has never been best served by extreme political ideologies. Franklin Roosevelt perhaps put it best: the question, he said, is "whether individual men and women will have to serve some system of government or economics, or whether a system of government and economics exists to serve individual men and women."[31] Not only is

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[29] Letter from Third Avenue Funds Chairman of the Board Martin J. Whitman to Shareholders, at 6 (Oct. 31, 2005) (online at www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-05Q4.pdf).

[30] Abraham Lincoln, *Speeches and Writings, 1832–1858: Speeches, Letters, and Miscellaneous Writings,* at 301 (Don Edward Fehrenbacher ed., 1989).

[31] Franklin Roosevelt, *Remarks to the Commonwealth Club* (Sept. 23, 1932) (online at

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this pragmatic approach democratic, asking regulation and the market to serve the American people, but it also places the American people at the foundation of the economy. If Americans are secure and flourishing, the financial system will be secure and flourishing as well. If Americans are in crisis or face considerable risks, so too will the financial system. Success is defined by the quality of life Americans have, not by the impersonal metrics of any theory of government or economics.

Well-conceived financial regulation has the potential not only to safeguard markets against excesses and abuse but also to strengthen markets as foundations of innovation and growth. Creativity and innovation are too often channeled into circumventing regulation and exploiting loopholes. Smart financial regulations can redirect creative energy from these unproductive endeavors to innovations that increase efficiency and address the tangible risks people face.[32] As discussed above, the decades following the New Deal regulatory reforms were the longest period without a serious finanial crisis in the nation's history; they were also a period of unusually high average real economic growth.

In April 2008, former Federal Reserve Chairman Paul Volcker commented on these developments in a speech to the Economic Club of New York:

> [T]oday's financial crisis is the culmination, as I count them, of at least five serious breakdowns of systemic significance in the past twenty-five years—on the average one every five years. Warning enough that something rather basic is amiss.
>
> Over that time, we have moved from a commercial bank–centered, highly regulated financial system, to an enormously more complicated and highly engineered system. Today, much of the financial intermediation takes place in markets beyond effective official oversight and supervision, all enveloped in unknown trillions of derivative instruments. It has been a highly profitable business, with finance accounting recently for 35 to 40 percent of all corporate profits.
>
> It is hard to argue that the new system has brought exceptional benefits to the economy generally. Economic growth and productivity in the last twenty-five years has been comparable to that of the 1950s and '60s, but in the earlier years the prosperity was more widely shared.
>
> The sheer complexity, opaqueness, and systemic risks embedded in the new markets—complexities and risks little understood even by most of those with management responsibilities—has enormously complicated both official and private responses to this current mother of all crises....
>
> Simply stated, the bright new financial system—for all its talented participants, for all its rich rewards—has failed the test of the market place....
>
> In sum, it all adds up to a clarion call for an effective response.[33]

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www.americanrhetoric.com/speeches/fdrcommonwealth.htm).

[32] Congressional Oversight Panel, Testimony of Joseph E. Stiglitz, *Reforming America's Financial Regulatory Structure*, at 3 (Jan. 14, 2009) (online at cop.senate.gov/documents/testimony-011409-stiglitz.pdf).

[33] Paul A. Volcker, *Address to the Economic Club of New York*, at 1-2 (Apr. 8, 2008) (online at econclubny.org/files/Transcript_Volcker_April_2008.pdf). In his address, Volcker recalled the financial troubles of New York City in 1975—that having been the last time he addressed the Economic Club of New York (then as President of

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As Volcker himself went on to observe, there is no going back to the "heavily regulated, bank dominated, nationally insulated markets" of the past.[34] At the same time, given the enormity of the current crisis and the evident failure of financial markets to regulate themselves, it is imperative that Congress take up the challenge of fashioning appropriate regulation for the twenty-first century—to stabilize and strengthen the nation's financial markets in the face of extraordinary innovation and globalization. For this to work, we must first remind ourselves that government has a vital role to play, not in replacing financial markets or overwhelming them with rules, but in bolstering financial markets through judicious regulation. Rooted in the principles of sound risk management, transparency, and fairness, new financial regulation can succeed, and must succeed.

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the Federal Reserve Bank of New York). Volcker noted in his 2008 address, "Until the New York crisis, the country had been free from any sense of financial crisis for more than forty years." *Id.* at 1.

[34] *Id.* at 3.

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IV. Critical Problems and Recommendations for Improvement

The sweeping nature of the current financial crisis points to the need for a thorough review of financial regulation and, ultimately, for significant regulatory reform. As discussed in part III, financial regulation is particularly necessary to manage risk, facilitate transparency, and ensure fair dealings. The current system has failed on all counts, and as a result, numerous discrete problems have emerged. This report focuses on the following most critical of these problems:

1. Systemic risk is often not identified or regulated until crisis is imminent.
2. Many financial institutions carry dangerous amounts of leverage.
3. The unregulated "shadow financial system" is a source of significant systemic risk.
4. Ineffective regulation of mortgages and other consumer credit products produces unfair, and often abusive, treatment of consumers, but also creates risks for lending institutions and the financial system.
5. Executive pay packages incentivize excessive risk.
6. The credit rating system is ineffective and plagued with conflicts of interest.
7. The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that increase market risk.
8. Participants, observers, and regulators neither predicted nor developed contingency plans to address the current crisis.

This section addresses each problem in turn, and provides recommendations for improvement.

1. Identify and Regulate Financial Institutions that Pose Systemic Risk

***Problem with current system*: Systemic risk is often not identified or regulated until crisis is imminent.**

Today, there is no regulator with the authority to determine which financial institutions or products pose a systemic risk to the broader economy. In 2008, Bear Stearns, Fannie Mae, Freddie Mac, AIG, and Citigroup all appear to have been deemed too big—or, more precisely, too deeply embedded in the financial system—to fail. The decisions to rescue these institutions were often made in an ad hoc fashion by regulators with no clear mandate to act nor the proper range of financial tools with which to act.

This is the wrong approach. Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools. Once a crisis has arisen, financial regulation has already failed. The underlying problem can no longer be prevented, it can only be managed, often at the cost of extraordinary expenditures of taxpayer dollars.

***Action item*: Mandate that a new or existing agency or an interagency task force regulate systemic risk within the financial system on an ongoing basis.**

A much better approach would be to identify the degree of systemic risk posed by financial institutions, products, and markets in advance—that is, in normal times—and to regulate them accordingly. Providing proper oversight of such institutions would help to prevent a crisis from striking in the first place, and it would put public officials in a much better position to deal with the

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consequences should a crisis occur.[35]

To make this possible, Congress and the President should designate a body charged with identifying the degree of systemic risk posed by financial institutions, products, and markets. This body could be an existing agency, such as the Board of Governors of the Federal Reserve System, a new agency, or a coordinating body of existing regulators.[36]

The need for a body to identify and regulate institutions with systemic significance is a necessary response to two clear lessons of the current financial crisis: (1) systemic risk is caused by institutions that are not currently covered or adequately covered by the financial services regulatory system; and (2) in a crisis the federal government may feel compelled to stabilize systemically significant institutions. However, no regulatory body currently has the power to identify and regulate systemically significant nonbank institutions. Consequently, Congress should authorize legitimate, coherent governmental powers and processes for doing so.

The systemic regulator should have the authority to require reporting of relevant information from all institutions that may be systemically significant or engaged in systemically significant activities. It should have a process for working with the regulatory bodies charged with the day-to-day oversight of the financial system. Finally, it should have clear authority and the proper tools for addressing a systemic crisis.

The regulator should operate according to the philosophy that systemic risk is a product of the interaction of institutions and products with market conditions. Thus, the regulator would oversee structures described in the next two action items that address a continuum of systemic risk by increasing capital and insurance requirements as financial institutions grow. This approach seeks to maximize the incentives for private parties to manage risk while recognizing and acting upon the fact that as financial institutions grow they become more "systemically significant."

Finally, creating a systemic risk regulator is not a substitute for ongoing regulation of our capital markets, focused on safety and soundness, transparency, and accountability. The agencies charged with those missions must be strengthened while we at the same time address the problem of systemic risk.

***Action item*: Impose heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crisis.**

Precisely because of the potential threat they pose to the broader financial system, systemically significant institutions should face enhanced prudential regulation to limit excessive risk taking and help ensure their safety. Such regulation might include relatively stringent capital and liquidity requirements, most likely on a countercyclical basis; an overall maximum leverage ratio (on the whole institution and potentially also on individual subsidiaries); well-defined limits on contingent liabilities and off-balance-sheet activity; and perhaps also caps on the proportion of short-term debt on the institution's balance sheet. The systemic regulator should consider the desirability of capping

[35] *See* Moss, *supra* note 3.

[36] Vesting that authority in an existing agency, such as the Board of Governors of the Federal Reserve, would require attention to the issues of transparency and accountability that the Panel will consider further when it looks at regulator structure.

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any taxpayer guarantee and whether to require systemically significant firms to purchase federal capital insurance under which the bank, in return for a premium payment, would receive a certain amount of capital in specified situations.[37]

Whether such enhanced oversight for systemically significant institutions should be provided by a new systemic regulator or by existing regulatory agencies is a question that requires further study and deliberation.

***Action item*: Establish a receivership and liquidation process for systemically significant nonbank institutions that is similar to the system for banks.**

The current bankruptcy regime under the Bankruptcy Code does not work well for systemically significant nonbanks institutions. Recent experience with the failure of Bear Stearns & Co. and Lehman Brothers Inc. has indicated that there are gaps in the system for handling the receivership or liquidation of systemically significant financial institutions that are not banks or broker-dealers and are therefore subject to the Bankruptcy Code. Two problems are evident: (1) Because the federal bankruptcy system was not designed for a large, systemically significant financial institution, financial regulators may feel the need to prop up the ailing institution in order to avoid a messy and potentially destructive bankruptcy process, and (2) the Bankruptcy Code's provisions for distribution of the assets of a bankrupt financial institution do not take into account the systemic considerations that regulators are obligated to consider.

The Panel recommends that systemically significant nonbank financial institutions be made subject to a banklike receivership and liquidation scheme. We note that the bankruptcy regime under the Federal Deposit Insurance Act has generally worked well.

2. Limit Excessive Leverage in American Financial Institutions

***Problem with current system*: Excessive leverage carries substantial risks for financial institutions.**

Leverage within prudent limits is a valuable financial tool. But excessive leverage in the financial sector is dangerous and can pose a significant risk to the financial system. In fact, it is now widely believed that overleveraging (i.e., relying on an increasingly steep ratio of borrowing to capital) at key financial institutions helped to convert the initial subprime turmoil in 2007 into a full-blown financial crisis in 2008.

Recent estimates suggest that just prior to the crisis, investment banks and securities firms, hedge funds, depository institutions, and the government-sponsored mortgage enterprises (primarily Fannie Mae and Freddie Mac) held assets worth nearly $23 trillion on a base of $1.9 trillion in capital, yielding an overall average leverage ratio of approximately 12:1. We must, however, consider this figure carefully, because average leverage varied widely for different types of financial institutions. The most heavily leveraged, as a class, were broker-dealers and hedge funds, with an average leverage ratio of 27:1; government sponsored enterprises were next, with an average ratio of 23.5:1.35. Commercial banks were toward the low end, with an average ratio of 9.8:1, and savings banks have the lowest average ratio at 8.7:1.

[37] *See* Moss, *supra* note 3.

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Financial institutions pursue leverage for numerous reasons. All bank lending, for example, is leveraged, because a certain amount of capital is permitted to support a much larger volume of loans. And the leverage of financial institutions is generally procyclical, meaning that it tends to increase when asset prices are rising (when leverage seems safer) and tends to decline when they are falling (when leverage seems more dangerous).[38]

For an institution with high debt and a relatively small base of capital, returns on equity are greatly magnified. Unfortunately, high leverage can also prove destabilizing because it effectively magnifies losses as well as gains. If a firm with $10 billion in assets is leveraged 10:1, then a loss of just 3 percent ($300 million) on total assets translates into a 30 percent decline in capital (from $1 billion to $700 million), raising the bank's leverage ratio to nearly 14:1. The challenge is obviously far more extreme for a firm with leverage of 30:1, as was typical for leading investment banks prior to the crisis. Here, a 3 percent ($300 million) loss on total assets translates into a 90-percent decline in capital (from $333 million to $33 million) and a new leverage ratio of nearly 300:1. To get back to leverage of 30:1, that firm would either have to raise $300 million in new equity (to bring capital back to its original level) or collapse its balance sheet, selling more than 95 percent ($9.37 billion) of its assets and paying off an equivalent amount of debt.[39]

Although raising $300 million in new equity would seem vastly preferable to selling $9.37 billion in assets, the problem is that financial institutions with depleted capital often find it difficult to raise new equity, particularly in times of general financial distress. If sufficient new capital is not available and the weakened firms are ultimately forced to dispose of assets under firesale conditions, this can depress asset prices further, generating additional losses across the financial system (particularly in the context of mark-to-market accounting). In the extreme, these sales can set off a vicious downward spiral of forced selling, falling prices, rising losses and, in turn, more forced selling.

***Action item*: Adopt one or more regulatory options to strengthen risk-based capital and curtail leverage.**

The goal of enhanced capital requirements is to limit excessive risk taking during boom times and reducing the need for dangerous "fire sales" during downturns. Several common criteria must be met by proposals for enhanced capital requirements. Above all, any such proposals must operate in a way that does not restrict prudent leverage or produce other unintended consequences. Moreover, they must recognize that proper risk adjustment can prove particularly vexing: the appropriateness of a leverage ratio depends on the safety of the assets the leverage supports, both directly and in the

[38] Tobias Adrian and Hyun Song Shin, *Liquidity, Monetary Policy, and Financial Cycles*, Current Issues in Economics and Finance, at 1–7 (Jan./Feb. 2008). Some have argued that high leverage—especially short-term debt—may have a positive governance impact by imposing tough discipline on the management of financial institutions. K. Kashyap, Raghuram G. Rajan, and Jeremy Stein, *Rethinking Capital Regulation* (Aug. 2008) (online at www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.08.08.08.pdf) (paper prepared for Federal Reserve Bank of Kansas City symposium on "Maintaining Stability in a Changing Financial System" in Jackson Hole, Wyoming). Given the experiences of the last year, however, this theory requires a good deal more research.

[39] This illustration was inspired by: Brandeis University Rosenberg Institute of Global Finance and University of Chicago Initiative on Global Markets, David Greenlaw, et al., *Leveraged Losses: Lessons from the Mortgage Market Meltdown* (2008) (U.S. Monetary Forum Report No. 2) (online at research.chicagogsb.edu/igm/docs/USMPF_FINAL_Print.pdf); David Scharfstein, *Why Is the Crisis a Crisis* (Dec. 2, 2008) (slide presentation prepared for Colloquium on the Global Economic Crisis, Harvard Business School).

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context of the business as a whole. Determining that safety level is anything but easy, as the current crisis shows. Finally, any proposal must recognize that no one solution will fit the entire financial sector (or perhaps even all institutions of one type within the financial sector).

A number of valuable ideas have been proposed as ways to strengthen capital and curtail excessive leverage, including the following:

Objectives-based capital requirements. Under this approach, capital requirements should be applied not simply according to the type of institution (commercial bank, broker-dealer, hedge fund, etc.) but on the basis of regulatory objectives (for example, guard against systemic risk, etc.). For example, required capital ratios could be made to increase progressively with the size of the firm's balance sheet, so that larger financial institutions face a lower limit on leverage than smaller ones (on the assumption that larger firms have greater systemic implications and ultimately become "too big to fail"). Required capital ratios could also be made to vary with other variables that regulators determine to be salient, such as the proportion of short-term debt on an institution's balance sheet or the identity of the holders of its liabilities.

Leverage requirements. Beyond risk-based capital requirements, there is also a strong argument for unweighted capital requirements, to control overall leverage. Stephen Morris and Hyun Song Shin suggest that these "leverage requirements" are necessary to limit systemic risk, by reducing the need for dangerous asset fire sales in a downturn.[40] FDIC Chairperson Sheila Bair has been particularly insistent on this point, declaring in 2006, for example, that "the leverage ratio—a simple tangible capital to assets measure—is a critically important component of our regulatory capital regime."[41] It should be noted that the current crisis may be exacerbated because leverage ratios are not a common feature of banking regulation in Europe; any approach to curtailing leverage in a globalized financial system must implement such standards on a global basis.

Countercyclical capital requirements. To help financial institutions prepare for the proverbial rainy day and manage effectively in a downturn, it has been proposed that capital (and provisioning) requirements be made countercyclical—that is, more stringent when asset prices are rising and less stringent when they are falling. Since the procyclicality of financial institution leverage likely intensifies the ups and downs in asset markets, countercyclical capital requirements could serve as a valuable automatic stabilizer, effectively leaning against the wind. One approach could involve a framework that raises capital adequacy requirements by a ratio linked to the growth of the value of bank's assets in order to tighten lending and build up reserves when times are good. Spain's apparently favorable experience with "dynamic provisioning" in its banking regulation serves as a

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[40] Brookings Institute, Stephen Morris and Hyun Song Shin, *Financial Regulation in a System Context*, at 21–26 (2008) (online at www.brookings.edu/economics/bpea/~/media/Files/Programs/ES/BPEA/2008_fall_bpea_papers/2008_fall_bpea_morris_shin.pdf). *See also id.* at 23 ("Instead of risks on the asset side of the balance sheet, the focus is on the liabilities side of balance sheets, and the potential spillover effects that result when financial institutions withdraw funding from each other. Thus, it is raw assets, rather than risk-weighted assets that matter.").

[41] Federal Deposit Insurance Corporation, *Remarks by Sheila C. Bair, Chairman before the Conference on International Financial Instability: Cross-Border Banking and National Regulation, Federal Reserve Bank of Chicago and the International Association of Deposit Insurers* (Oct. 5, 2006) (online at www.fdic.gov/news/news/speeches/archives/2006/chairman/spoct0606.html).

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model for many related proposals.[42] Joseph Stiglitz takes the idea one step further, suggesting that a "simple regulation would have prevented a large fraction of the crises around the world—speed limits restricting the rate at which banks can expand, say, their portfolio of loans. Very rapid rates of expansion are typically a sign of inadequate screening."[43] Similarly, because rapid increases in leverage appear to precede periods of financial turmoil, capital requirements could be tailored to discourage particularly quick buildups of leverage.

Liquidity requirements. To further address the problem of financial firms being forced to sell illiquid assets into a falling market, some commentators have proposed that regulators could impose liquidity requirements in addition to capital requirements, so that financial firms would have to hold a certain proportion of liquid assets as well as a liquidity buffer that could be used in a crisis. Armed with sufficient supply of liquid assets (such as treasury bills), firms could safely sell these assets in a downturn without placing downward pressure on the prices of less liquid assets, which would contribute to systemic risk.[44]

These and other proposals will need to be thoughtfully reviewed, bearing in mind that leverage is not a consistent phenomenon, but rather varies across financial institutions, regulatory structures, and different types of leveraged situations. The current crisis provides two lessons to inform this review. First, options to curtail excessive leverage must proceed as a top priority and an integral part of the restructuring of the regulation of American financial institutions. Second, reforms in this area must reflect the primary lesson of the crisis: that no asset types, however labeled, and no transaction patterns, however familiar, are inherently stable.

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[42] *See, e.g., Spanish Steps: A Simple Way of Curbing Banks' Greed*, Economist (May 15, 2008) (online at www.economist.com/specialreports/displaystory.cfm?story_id=11325484).

[43] House Financial Services Committee, Testimony of Joseph Stiglitz, *The Future of Financial Services Regulation*, 110th Cong. (Oct, 21, 2008) (online at financialservices.house.gov/hearing110/stiglitz102108.pdf). Stiglitz also notes that there are "several alternatives to speed limits imposed on the rate of expansion of assets: increased capital requirements, increased provisioning requirements, and/or increased premia on deposit insurance for banks that increase their lending (lending in any particular category) at an excessive rate can provide incentives to discourage such risky behavior." *Id.*

[44] Liquidity requirements can mitigate contagion, and can play a similar role to capital buffers in curtailing systemic failure. In some cases, liquidity may be more effective than capital buffers in forestalling systemic effects. When asset prices are extremely volatile, for example during periods of major financial distress, even a large capital buffer may be insufficient to prevent contagion, since the price impact of selling into a falling market would be very high. Liquidity requirements can mitigate the spillover to other market participants generated by the price impact of selling into a falling market. Moreover, because financial institutions do not recognise the indirect benefits of adequate liquidity holdings on other network members (and more generally on system resilience), their liquidity choices will be suboptimal. As a result, liquidity and capital requirements need to be imposed externally, in relation to a bank's contribution to systemic risk.

Bank of England, Rodrigo Cifuentes, Gianluigi Ferrucci, and Hyun Song Shin, *Liquidity Risk and Contagion* (2005) (Working Paper No. 264) (online at www.bankofengland.co.uk/publications/workingpapers/wp264.pdf).

U.S. bank regulators monitor a bank's liquidity as part of their Uniform Financial Institutions Ratings (CAMELS) System. *See, e.g.*, Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual*, Sec. 2020.1.

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3. Modernize Supervision of Shadow Financial System

***Problem with current system*: The unregulated "shadow financial system" is a source of significant systemic risk.**

Since 1990, certain large markets and market intermediary institutions have developed outside the jurisdiction of financial market regulators. Collectively, these markets and market actors have become known as the shadow financial system.[45] The key components of the shadow financial system are unregulated financial instruments such as over-the-counter (OTC) derivatives, off-balance-sheet entities such as conduits and SIVs,[46] and nonbank institutions such as hedge funds and private equity funds. While the shadow financial system must be brought within any plan for systemic risk management, that alone would be insufficient. Routine disclosure-based capital-market regulation and routine safety-and-soundness regulation of financial institutions will not function effectively unless regulators have jurisdiction over the shadow financial system and are able to enforce common standards of transparency, accountability, and adequate capital reserves.

As a result of the growth of the shadow financial system, it is nearly impossible for regulators or the public to understand the real dynamics of either bank credit markets or public capital markets. This became painfully clear during the collapse of Bear Stearns and the subsequent bankruptcy of Lehman Brothers, and the collapse of AIG. In the case of Bear Stearns, key regulators expressed the view that as a result of that firm's extensive dealing with hedge funds and in the derivatives markets, the systemic threat posed by a disorderly bankruptcy could prove quite severe, though difficult to predict with any certainty.[47] Six months later, Lehman Brothers was allowed to file for protection under Chapter 11, the only major financial firm to be allowed to do in the United States

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[45] *See, e.g.*, Bill Gross, *Beware Our Shadow Banking System*, Fortune (Nov. 28, 2007) (online at money.cnn.com/2007/11/27/news/newsmakers/gross_banking.fortune); Nouriel Roubini, *The Shadow Banking System is Unraveling*, Financial Times (Sept. 21, 2008) (online at www.ft.com/cms/s/0/622acc9e-87f1-11dd-b114-0000779fd18c.html).

[46] Off-balance sheet entities are a significant part of the shadow financial system, and are addressed in part in our earlier recommendations on leverage, and in part should be the subject of a more extended technical inquiry into reforming Financial Accounting Standard 140.

[47] In a speech on August 22, 2008, Federal Reserve Chairman Ben Bernanke spoke frankly about the potential for a Bear Stearns failure to echo throughout the financial system:

> Although not an extraordinarily large company by many metrics, Bear Stearns was deeply involved in a number of critical markets, including (as I have noted) markets for short-term secured funding as well as those for over-the-counter (OTC) derivatives. One of our concerns was that the infrastructures of those markets and the risk- and liquidity-management practices of market participants would not be adequate to deal in an orderly way with the collapse of a major counterparty. With financial conditions already quite fragile, the sudden, unanticipated failure of Bear Stearns would have led to a sharp unwinding of positions in those markets that could have severely shaken the confidence of market participants. The company's failure could also have cast doubt on the financial conditions of some of Bear Stearns's many counterparties or of companies with similar businesses and funding practices, impairing the ability of those firms to meet their funding needs or to carry out normal transactions. As more firms lost access to funding, the vicious circle of forced selling, increased volatility, and higher haircuts and margin calls that was already well advanced at the time would likely have intensified. The broader economy could hardly have remained immune from such severe financial disruptions.

Board of Governors of the Federal Reserve System, *Chairman Ben S. Bernanke Remarks on Reducing Systemic Risk before the Federal Reserve Bank of Kansas City's Annual Economic Symposium* (Aug. 22, 2008) (online at www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm).

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during the financial crisis. Lehman's bankruptcy resulted in substantial systemwide disruption, particularly as a result of credit default swap obligations triggered by Lehman's default on its debt obligations. The unregulated nature of several financial markets involved in this crisis contributed to the inability of regulators to understand the unfolding problems and act responsively.

***Action item*: Ensure consistency of regulation for instruments currently operating in the shadow financial system.**

Extending the reach of financial regulation to cover the shadow financial system is necessary in order to accurately measure and manage risk across the markets. A consistent regulatory regime will also reduce the ability of market players to escape regulation by using complex financial instruments and to secure higher yields by masking risk through information asymmetries.

The Panel urges Congress to consider shifting the focus of existing regulation toward a functional approach. While the details would need to be worked out by empowered regulators, the principle is simple: hedge funds and private equity funds are money managers and should be regulated according to the same principles that govern the regulation of money managers generally. At a minimum, Congress must grant the SEC the clear authority to require hedge fund advisors to register as investment advisors under the Investment Advisors Act. If they venture into writing insurance contracts or providing credit to others, hedge funds' activities in these areas need to be regulated according to the principles governing insurance or lending. An over-the-counter derivative can be almost any kind of contract synthesizing almost any kind of economic act—such instruments need to be regulated according to what they do, not what they are called.

While further study is needed, proposals for regulating more consistently instruments currently in the shadow financial system include: applying capital requirements to firms engaged in making credit or insurance commitments through derivatives; requiring transparency around derivatives contracts tied to publicly traded securities; and holding hedge funds and private equity funds to a single, well-understood federal standard of fiduciary duty as other money managers are. However, regulating the shadow markets does not necessarily mean treating a hedge fund in the same manner as a mutual fund, or a credit default swap between institutions in the same manner as an insurance policy sold to retail consumers. Functional regulation can mean applying the same principles and not necessarily producing identical regulatory outcomes.

***Action item*: Increase transparency in OTC derivatives markets.**

The Panel also recommends implementing new measures to improve transparency in the shadow financial system. Lack of transparency in the shadow financial system contributed to failures of risk management and difficulty in pricing assets and assessing the health of financial institutions. Transparency can be enhanced in several ways; several options are presented below:

Regulated clearinghouses. A clearinghouse is an entity that provides clearance and settlement services with respect to financial products. It acts as a central counterparty with respect to trades that it clears. When the original parties to the trade introduce it to the clearinghouse for clearing, the original trade is replaced by two new trades in which the clearinghouse becomes the buyer to the original seller and the seller to the original buyer.

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Proposals for clearinghouses generally involve the clearinghouse itself taking on credit risk. Such credit risk raises the issue of how to provide adequate capital in case of a default. One method for doing so involves taking the "margin" to secure performance of each trade. Another method involves daily marks-to-market to reduce risk arising from price fluctuations in the value of the contract. Others have proposed guaranty funds, in which each of the clearing members of the clearinghouse puts up a deposit to cover its future liabilities. Most central counterparty proposals also involve "mutualization of risk," in which the guaranty fund deposits of all clearing members may be used to cover a default by one member if the defaulting member's margin payments and guaranty fund contribution are insufficient to cover the loss. Finally, a clearinghouse may have the right to call for further contributions from members to cover any losses.

In addition to regulators risk management principles, a clearinghouse structure may also involve inspection by federal for the purposes of detecting and punishing fraudulent activity and public reporting of prices, volumes and open interest.[48]

Exchange-traded derivatives. As an alternative to clearinghouses, regulators can require that all standardized—and standardizable—OTC derivatives contracts be traded on regulated derviatives markets. These markets would be governed by the same standards that guide designated contract markets under the Commodity Exchange Act (CEA). CEA-governed exchanges must fully disclose the terms of the contracts traded and rules governing trading, and must also publicly report prices, volumes and open interest. The exchange would maintain detailed records to be inspected by federal regulators and would be empowered with the ability to deter, detect, and punish fraudulent activity. Intermediaries participating in the exchange would face registration, reporting, and capital adequacy requirements as well. Finally, the exchanges could still make use of clearinghouses to minimize counterparty risk.

Public reporting requirements. SEC Chairman Christopher Cox has proposed requiring CDS market participants to adhere to a public disclosure regime that would allow regulators to monitor market risk and potential market abuse. Cox's proposals include: (1) public reports of OTC transactions to improve transparency and pricing, and (2) reporting to the SEC derivatives positions that affect public securities.[49]

4. Create a New System for Federal and State Regulation of Mortgages and other Consumer Credit Products

***Problem with current system*: Ineffective regulation of mortgages and other consumer credit products has produced unfair, and often abusive, treatment of consumers, which destabilizes both families and the financial institutions that trade in those products.**

For decades, default rates on traditional home mortgages were low; profits to mortgage lenders were steady. Millions of Americans used mortgages to enable them to buy homes and retain homes. Over

[48] *See* President's Working Group on Financial Markets, *Policy Objectives for the OTC Derivatives Market* (Nov. 14, 2008) (online at www.treas.gov/press/releases/reports/policyobjectives.pdf).

[49] Christopher Cox, *Swapping Secrecy for Transparency*, New York Times (Oct. 18, 2008) (online at www.nytimes.com/2008/10/19/opinion/19cox.html).

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time, however, a number of mortgage lenders and brokers began offering higher-priced, higher-profit—and higher risk—mortgages to millions of families.[50] Unlike the low-risk "prime" mortgages of the 1940s through the 1990s, the new "subprime" offered much bigger payouts for lenders and, ultimately, for the investors to whom the lenders sold these mortgages, but they also created higher costs and greater risks for consumers. For example, a family buying a $175,000 home with a subprime loan with an effective interest rate of 15.6 percent would pay an extra $420,000 during the 30-year life of the mortgage—that is, over and above the payments due on a prime 6.5 percent mortgage. While investors were attracted to the bigger returns associated with these subprime mortgages, many overlooked the much bigger risks of default that have now become glaringly apparent.

The new subprime mortgages were marked by exotic, and often predatory, new features, such as two year teaser rates that permitted marketing of mortgages to individuals who could not have qualified for credit at the enormous required rate increase in year three, or so-called "liars" or "no-doc" loans based on false paperwork about a borrower's financial situation. Terms such as these virtually guaranteed that the mortgages would default, and families would lose their homes, unless the real estate price inflation continued. These mortgages were especially cruel for new, especially lower-income, home buyers. The data show, however, that a substantial number of middle-income families (and even some upper-income families) with low default risk signed up for subprime loans that were far more expensive than the prime mortgages for which they qualified.

The complexity of subprime mortgage products made understanding the costs associated with an offered mortgage, let alone comparing several mortgage products, almost impossible. The high proportion of people with good credit scores who ended up with high-cost mortgages raises the specter that some portion of these consumers were not fully cognizant of the fact that they could have borrowed for much less.[51] This conclusion is further corroborated by studies showing that

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[50] *See* Federal Reserve Board, Christopher J. Mayer, Karen M. Pence, and Shane M. Sherlund, *The Rise in Mortgage Defaults*, at 2 (2008) (Finance and Economics Discussion Series No. 2008-59) (online at www.federalreserve.gov/Pubs/feds/2008/200859/200859pap.pdf) ("According to data from the Mortgage Bankers Association, the share of mortgage loans that were 'seriously delinquent' (90 days or more past due or in the process of foreclosure) averaged 1.7 percent from 1979 to 2006… But by the second quarter of 2008, the share of seriously delinquent mortgages had surged to 4.5 percent."). For detailed historical data on prime and subprime mortgages, *see* Mortgage Bankers Association, *National Delinquency Survey* (online at www.mbaa.org/ResearchandForecasts/productsandsurveys/nationaldelinquencysurvey.htm).

[51] In 2002, for example, researchers at Citibank concluded that at least 40 percent of those who were sold high interest rate, subprime mortgages would have qualified for prime-rate loans. Lew Sichelman, *Community Group Claims CitiFinancial Still Predatory*, Origination News, at 25 (Jan. 2002) (reporting on new claims of CitiFinancial's predatory practices after settlements with state and federal regulators). Freddie Mac and Fannie Mae estimate that between 35 percent and 50 percent of borrowers in the subprime market could qualify for prime market loans. *See* James H. Carr & Lopa Kolluri, *Predatory Lending: An Overview*, in Fannie Mae Foundation, *Financial Services in Distressed Communities: Issues and Answers,* at 31, 37 (2001). *See also* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, Maryland Law Review, at 730 (2006). A study by the Department of Housing and Urban Development of all mortgage lenders revealed that 23.6 percent of middle-income families (and 16.4 percent of upper-income families) who refinanced a home mortgage ended up with a high-fee, high-interest subprime mortgage. U.S. Department of Housing and Urban Development, Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending*, at 28 (2002) (Working Paper No. HF-014) (online at www.huduser.org/Publications/pdf/workpapr14.pdf). A study conducted for the Wall Street Journal showed that from 2000 to 2006, 55 percent of subprime mortgages went to borrowers with credit scores that would have qualified them for lower-cost prime mortgages. Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even the Very Credit Worthy; As*

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subprime mortgage prices cannot be fully explained by borrower-specific and loan-specific risk factors.[52] These difficulties were further exacerbated by sharp selling practices and delayed disclosure of relevant documents. Buyers were steered to overpriced mortgages by brokers or other agents who represented themselves as acting in the borrower's best interests, but who were taking commissions from subprime lenders to steer them to riskier mortgages.[53] In other cases, lenders would not make relevant documents available until the closing date. In all of these respects, the mortgage market simply failed consumers.

Although mortgage documents include a raft of legally-required disclosures, those disclosures are a long way from a meaningful understanding of the loan transaction—and a much longer distance from supporting competitive markets. Many of the same points can be made for credit cards and other consumer financial products. In all of these cases consumers have little access to the key information they need to make responsible decisions. The result is a market in which people fail to assess risks properly, over-pay, and get into financial trouble. As the current crisis shows, these effects are not confined to those who buy the credit products. The high risk that consumers could not pay back their loans was multiplied by the bundling and re-bundling of millions of the loans into asset-backed securities;. That rebundling, in turn, spread the risk further, to the investment portfolios of other financial institutions, pension funds, state and local governments, and other investors for whom such risk was not appropriate. Ultimately, the widespread marketing of high-cost, high-risk consumer products has contributed to the destabilizing of the entire economy.

If, for example, a home buyer had been required to demonstrate an ability to pay the long-term mortgage rate rather than the teaser rate, home owners—and the country—would have been spared the specter of millions of foreclosures when payment resets made the monthly payment unaffordable. Moreover it would have been impossible to offer flawed investment products based on such mortgages.

State regulators have a long history as the first-line of protection for consumers. For example, states first sounded the alarm against predatory lending and brought landmark enforcement actions against some of the biggest subprime lenders, including Household, Beneficial Finance, AmeriQuest, and

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Housing Boomed, Industry Push Loans to a Broader Market, Wall Street Journal (Dec. 3, 2007) (study by First American Loan Performance for the Journal). By 2006, that proportion had increased to 61 percent. *Id.* None of these studies is definitive on the question of overpricing because they focus exclusively on FICO scores, which are critical to loan pricing but are not the only factor to be considered in credit risk assessment. However, they suggest significant market problems.

[52] Joint Center for Housing Studies, Harvard University, Ren S. Essene and William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans*, at 2 (2007) (online at www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf) (quoting Fishbein and Woodall, *supra* note 28, at 24); Howard Lax, et al., *Subprime Lending: An Investigation of Economic Efficiency*, Housing Policy Debate, at 533 (2004).

[53] *See, e.g.*, Howell E. Jackson and Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* (Jan. 2002) (online at www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf). In some neighborhoods these brokers went door-to-door, acting as "bird dogs" for lenders, looking for unsuspecting homeowners who might be tempted by the promise of extra cash. Other families were broadsided by extra fees and hidden costs that didn't show up until it was too late to go to another lender. One industry expert described the phenomenon: "Mrs. Jones negotiates an 8% loan and the paperwork comes in at 10%. And the loan officer or the broker says, 'Don't worry, I'll take care of that, just sign here.'" Dennis Hevesi, *A Wider Loan Pool Draws More Sharks*, New York Times (Mar. 24, 2002).

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Delta Funding. But states are sometimes pressured to offer no more consumer protection than is offered on the federal level so that financial firms do not leave their state regulator for a more favorable regulatory environment (taking the fee revenues they provide with them). [54] Moreover, the same competition for business that exists at the state level also exists at the federal level. Federal regulators face the possibility of losing business both to state regulators or to other federal regulatory agencies. At the federal level, this problem is exacerbated by direct financial considerations. The budgets of the OCC and OTS, for example, are derived from the number and size of the financial institutions they regulate, which means that a bank's threat to leave a regulator has meaningful consequences.[55] As Professor Arthur Wilmarth has testified, "Virtually the entire [Office of the Comptroller of the Currency] budget is funded by national bank fees, and the biggest national banks pay the highest assessment rates.... The OCC's unimpressive enforcement record is, unfortunately, consistent with its strong budgetary incentive in maintaining the loyalty of leading national banks."[56]

This has caused much of the regulatory scheme to come unraveled. State usury laws have eroded; according to recent research, at least 35 states have amended their usury laws to make it legal to charge annual interest rates exceeding 300 percent in connection with consumer credit products.[57] Many states were apparently also unwilling to deal with subprime mortgages. In 2006, fully half—52 percent—of subprime mortgages originated with companies that were subject only to state regulation.[58] And now, as the mortgage crisis deepens, the National Association of Attorneys General has a highly visible working group on foreclosures, but only about half of the states participate.

In addition, the authority of the states to deal with consumer protection for credit products has been sharply limited by interpretations in federal law. First, the Supreme Court has ruled that the usury laws of a national bank's state of incorporation controlled its activities nationwide. The decision naturally produced the pressures for repeal of state usury protections noted above. Second, the Office of the Comptroller of the Currency and federal courts have interpreted the National Banking Act to pre-empt action by state regulators to apply state consumer protection laws to national banks or to operating subsidiaries of national banks; virtually all of the nation's large banks—and most of those receiving federal assistance under the TARP—are national banks. The OCC's action was prompted by the attempt of Georgia to apply its Fair Lending Act to all banks within its jurisdiction. Yet, despite promises to Congress and the states, federal regulators have made the problem worse

[54] In any of these situations, of course, the state from which the financial institution switches its charter is deprived of substantial revenue, and the new chartering jurisdiction gains substantial revenue.

[55] Michael Schroeder, *Bank Regulator Cleans House*, Wall Street Journal (Aug. 19, 2005) ("Bank consolidation has created competition among regulators. The OCC has been a winner in wooing banks to choose it as their regulator, helping to keep its coffers flush. Bank fees finance its $519 million annual budget, not taxpayer money.").

[56] *See, e.g.*, Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Arthur E. Wilmarth, Jr., *Review of the National Bank Preemption Rules*, 108th Cong. (Apr. 7, 2004) (online at banking.senate.gov/public/_files/wilmarth.pdf); Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, Temple Law Review, at 70–74, 77–84 (2005).

[57] Christopher L. Peterson, *Usury Laws, Payday Loans and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, Minnesota Law Review, at 1139 (2008).

[58] Greg Ip and Damian Palleta, *Regulators Scrutinized in Mortgage Meltdown*, Wall Street Journal (Mar. 27, 2007).

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by failing to provide any significant supervision or regulation of their own.[59]

***Action item*: Eliminate federal pre-emption of application of state consumer protection laws to national banks.**

Preemption affects states' consumer protection initiatives in three main respects:

1. *Standards*: The ability of states to set consumer protection laws and the scope of coverage for those laws.

2. *Visitation*: The ability of states to examine financial institutions for compliance with consumer protection laws.

3. *Enforcement*: The ability of states to impose penalties for violations of consumer protection laws.

Visitation and enforcement are closely connected but distinct.

Given the critical role of state consumer protection, Congress should amend the National Banking Act to provide clearly that state consumer protection laws can apply to national banks and to reverse the holding that the usury laws of a national bank's state of incorporation govern that bank's operation through the nation.

***Action item*: Create a single federal regulator for consumer credit products.**

The need for a uniform federal law to create a meaningful baseline of protections is clear. It is essential that one regulatory agency have the responsibility and accountability for drafting, implementing, and overseeing effective consumer credit product protection rules. Without a uniform set of minimum standards, regulatory arbitrage among state—and federal—regulators will continue. and no regulator or agency will have the authority and responsibility to protect consumers.

The new federal regulator must be responsible for establishing minimum standards for disclosure and transparency, reviewing consumer credit products (in a manner set by statute) in light of those standards to eliminate unfair practices, and promoting practices that encourage the responsible use of credit. This regulator should assure that consumers are not misled by the terms of the sales pitches for credit products and that they have the information needed to make informed and thoughtful purchasing decisions. The statement of purposes of the legislation creating the new agency, and the standards governing its actions, would include the need to balance consumer protection with the legitimate need of financial institutions to create fair products and maintain the flow of credit to the national economy.

Creation of a single federal regulator would produce a single, national floor for consumer financial products. Some state regulators might conclude that their citizens require better protection, and they might put other constraints on the institutions that want to do business in their states. This proposal

[59] *See, e.g., Watters v. Wachovia Bank*, 550 U.S. 1 (2007). *See also* Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, Minnesota Law Review (2004); Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, South Carolina Law Review (2000).

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leaves them free to do so. The regulatory agency simply assures that all Americans, regardless of where they live, can count on basic protection. Regulations that apply to all products of a certain kind—e.g., mortgages, credit cards, payday loans—without any exceptions are far more comprehensive than those based on the kind of institution that issued them—federally chartered, state charted, thrift, bank, etc. Because such baselines are inescapable, the impact of regulatory arbitrage is sharply undercut. A financial institution cannot escape the restrictions on mortgage disclosures, for example, by reincorporating from a federal bank to a state bank. Any issuer of home mortgages must meet the minimum federal standards.

One option is to make the new federal regulator an independent agency within the financial regulatory community. This approach would have several advantages. A single regulator would have the opportunity to develop significant expertise in consumer products. Consumer protection would be a priority rather than one issue among many competing with a myriad of other regulatory priorities that have consistently commanded more attention in financial institution regulatory agencies. An agency devoted to consumer protection can make it a first priority to understand the functioning of financial products in the consumer marketplace. Expertise can also be concentrated from around the country. A single group of regulators can develop greater expertise to ensure that products are comprehensible to customers and that they are protected from unfair business practices. Such expertise can also be transferred from one product to another. As financial products become more functionally intertwined—for example, home equity lines of credit that operate like credit cards—an agency can develop the needed cross-expertise and more nuanced rules.

Another option is to place the new regulator within the Federal Reserve Board. The Board is the umbrella supervisor of bank holding companies, and it directly supervises state-chartered banks that choose to become members of the Federal Reserve System. It was given specific authority to deal with deceptive mortgages more than forty years ago.[60] Congress voted repeatedly to expand the Board's power to provide stronger consumer protection.[61]

Placing the new regulator within the Board would keep safety and soundness and consumer protection responsibilities together, on the ground that each responsibility, if properly implemented, could complement and re-enforce the other. Choosing that option, however, would require changes to the Federal Reserve Act to make consumer protection one of the Fed's primary responsibilities, on a par with bank supervision. It would also depend on a new understanding and attitude by the Board toward its execution of its consumer protection mission.

Federal Reserve Chairman Ben Bernanke has acknowledged that although the powers of the Fed to deal with mortgage abuses were "broad,"[62] the Board has for years been slow to act,[63] and the

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[60] Truth in Lending Act (TILA), Pub. L. No. 90-321 (1968), at § 105(a) (codified as amended at 15 U.S.C. § 1601 et seq.) ("The Board shall prescribe regulations to carry out the purposes of this title."). The Federal Reserve Board implements TILA through its Regulation Z. 12 C.F.R. pt. 226. *See also* Home Ownership and Equity Protection Act of 1994 (HOEPA), Pub. L. No. 103-325 (codified at 15 U.S.C. § 1639) (amending TILA).

[61] Congress has amended TILA to improve consumer credit protection. *See, e.g.,* Fair Credit and Charge Card Disclosure Act of 1988, Pub. L. No. 100-583 (codified at 15 U.S.C. § 1637). In 1994, Congress amended TILA again to address predatory lending in the mortgage market. HOEPA, *supra* note 60.

[62] In 2007, Chairman Bernanke said the Board would "consider whether other lending practices meet the legal definition of unfair and deceptive and thus should be prohibited under HOEPA." Board of Governors of the Federal Reserve System, *Chairman Ben S. Bernanke Remarks on The Subprime Mortgage Market before the Federal Reserve*

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actions it took were inadequate.[64] Its power under TILA and HOEPA to issue regulations binding upon all mortgage lenders gave it the capacity to halt the lending practices that inflated the housing bubble and that lead millions of home owners toward eventual foreclosure, but the Fed failed to do so.

Similarly, in areas such as credit card regulation, only when Congress threatened to take away powers, did the Fed finally act.[65] Barney Frank, Chairman of the House Financial Services Committee, explained that the failure of the Fed to act was longstanding: "When Chairman Bernanke testified before us a few weeks ago . . . he said something I hadn't heard in my 28 years in this body, a Chairman of the Federal Reserve Board uttering the words, 'consumer protection.' It had not happened since 1981."[66]

Currently, the staffing, the budgets, the expertise and the primary responsibilities of the Fed necessarily reflect the critical functions it performs: setting monetary policy and controlling the money supply, consolidated supervision of bank holding companies and the financial institutions those holding companies own to assure the safety and soundness of those groups, supervision of state-chartered member-banks in coordination with state regulators, and oversight of the federal reserve banks. Under this option the Fed would be required to accept consumer protection as a responsibility that is the equal of its other responsibilities, staff and budget for that function and, makes its operations in the area transparent. These responsibilities should be subject to specific oversight by a designated Board member.

Wherever it is placed, the success of the new regulator would depend in part on a statutory outline of the manner in which it would be related to the various financial institution regulatory agencies, and how those agencies would relate to one another, in dealing with consumer credit products. The agencies that are responsible for assuring the safety and soundness of the financial institutions would be able to pursue those goals without interference. The point of the single regulatory authority would be only to assure that both financial institutions and non-financial institutions that issue consumer credit products must play on a level field, all meeting the minimum standards

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Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007) (online at www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm). In 2008, recognizing that its authority under HOEPA is "broad," the Board strengthened Regulation Z. 73 Fed. Reg. 44,522 (July 30, 2008).

[63] It was not until the end of 2001, after the volume of subprime loans had increased nearly 400 percent, that the Board restricted more abusive practices and broadened the scope of mortgages covered by HOEPA. *See* 66 Fed. Reg. 65,604, 65,605 (Dec. 20, 2001).

[64] The Fed updated Regulation Z in response to HOEPA in March 1995. 60 Fed. Reg. 15,463. It also amended Regulation C, "Home Mortgage Disclosure," in 2002. 67 Fed. Reg. 7222. Nonetheless, neither regulation was strong enough to head off the mortgage abuses that continued to accelerate through 2008.

[65] *See, e.g.*, Jane Birnbaum, *Credit Card Overhauls Seem Likely*, New York Times (July 5, 2008) ("Representative Barney Frank, Democrat of Massachusetts and chairman of the House Financial Services Committee, said the Federal Reserve acted last fall after the House approved legislation that would have transferred some of the Fed's regulatory power to other agencies. 'At that point, I said use it or lose it,' Mr. Frank recalled. 'And subsequent to that, the Fed began using its authority, and is now proposing rules similar to those in our credit card bill.'")

[66] House Financial Services Committee, Subcommittee on Financial Institutions and Consumer Credit, Statement of Chairman Barney Frank, *The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers*, 110th Cong. 5–6 (2008).

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established by the federal agency. No one issuer could gain advantage by moving to a different regulator.

5. Create Executive Pay Structures that Discourage Excessive Risk Taking

Problem with current system: **Executive pay packages incentivize excessive risk.**

Executive pay is a key issue in modernizing the financial regulatory system. However, the common focus on the themes of inequality and "pay for performance" misses the unnecessary risk that many compensation schemes introduce into the financial sector. Altering the incentives that encourage this risk through the tax code, regulation, and corporate governance reform will help mitigate systemic risk in future crises.

Executive compensation has been one of the most controversial issues in American business since the late 1980s. In response to criticism that executives' and shareholders' interests did not sufficiently align,[67] executive compensation packages began to contain more and more stock options, to the point where options now represent the lion's share of a high-ranking executive's pay.[68]

Much criticism of executive pay has had its origins in the increase in the ratio of the pay of public company executives to average worker pay, from 42:1 in 1982 to over 400:1 in the early years of this decade.[69] Recent executive pay scandals, such as those associated with the backdating of stock options, have centered on efforts by executives to disconnect pay from performance without informing investors.[70] Numerous accounts of executive pay in the context of the financial crisis of 2007–08 have focused on large severance packages, often described as once again disconnecting pay from performance.[71]

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[67] Steven Balsam, *An Introduction to Executive Compensation*, at 161 (2002).

[68] According to academic literature, between 1992 and 2002, the inflation-adjusted value of employee options granted by firms in the S&P 500 increased from an average of $22 million per company to $141 million per company, rising as high as $238 million per company in 2000. One academic study we referenced showed that, whereas in 1992 share options accounted for only 24 percent of the average pay package for these CEOs, by 2002 options comprised approximately half of the typical CEO's total compensation. The practice of granting option awards has not been limited to the top echelon of company executives. The percentage of option grants to all employees has grown steadily as well, if not at the same pace as the very top-most strata of corporate executives.

Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, Testimony of John W. White, *Concerning Tax and Accounting Issues Related to Employee Stock Option Compensation*, 110th Cong. (June 5, 2007) (online at idea.sec.gov/news/testimony/2007/ts060507jww.htm) (internal citations omitted).

[69] Jeanne Sahadi, *CEO Pay: Sky High Gets Even Higher*, CNNMoney.com (Aug. 30, 2005) (online at money.cnn.com/2005/08/26/news/economy/ceo_pay).

[70] *See, e.g.*, U.S. Securities Exchange Commission, *SEC Charges Former Apple General Counsel for Illegal Stock Option Backdating* (Apr. 24, 2007) (online at www.sec.gov/news/press/2007/2007-70.htm).

[71] The most prominent example is that of Angelo Mozilo, the former Chief Executive Officer of Countrywide Financial Corporation. Countrywide was rescued from bankruptcy by being acquired by Bank of America, which is now itself seeking additional financial assistance from the TARP. Mozilo realized more than $400 million in compensation from 2001 to 2007, most of it in the form of stock related compensation that he received and cashed out during the period. *Executive Incentives*, Wall Street Journal (Nov. 20, 2008) (online at

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However, even before the current crises, many criticized such incentive plans for encouraging excessive focus on the short term at the expense of consideration of the risks involved.[72] This short-term focus led to unsustainable stock buyback programs, accounting manipulations, risky trading and investment strategies, or other unsustainable business practices that merely yield short-term positive financial reports.

Executive pay should be designed, regulated, and taxed to incentivize financial executives to prioritize long-term objectives, and to avoid both undertaking excessive, unnecessary risk and socializing losses with the help of the federal taxpayer.

***Action item*: Create tax incentives to encourage long-term–oriented pay packages.**

Financial firm packages typically have a number of features that introduce short-term biases in business decision making. Most equity-linked compensation is either in the form of performance bonuses, typically awarded on an annual basis, and options on restricted stock, typically awarded in the form of grants with three-year vesting periods, and no restrictions on sale after vesting. These structures, together with the typical five-years-or-less tenure of public company CEOs, often lead to a focus on investment horizons of less than three years.[73]

Altering the tax treatment of executive compensation packages in the interests of encouraging stability, lessening risks, and orienting finance executives toward long-term goals represents a relatively simple step toward solving the incentive problem. Such a change could result from revising applicable tax rates, changing the treatment of compensation as income versus capital gains, or other relatively simple measures.

***Action item*: Encourage financial regulators to guard against asymmetric pay packages in financial institutions, such as options combined with large severance packages.**

Asymmetric links between compensation and risk create incentives for executives to pursue potentially systemically threatening high-risk–high-reward strategies without sufficient regard for the downside potential. Encouraging regulators to spot and discourage compensation packages that excessively insulate executives from losses will help resolve this asymmetry and promote stability.

Stock options create incentives that are tied to stock price, but the overall compensation package's asymmetric link to stock price actually helps encourage more dramatic risk taking. As the price of the underlying stock declines, the option holder become less sensitive to further declines in value of the underlying stock, and more interested in the possibility of achieving dramatic gains, regardless

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online.wsj.com/public/resources/documents/st_ceos_20081111.html). Similarly, three of Merrill Lynch's top executives realized a combined $200 million in bonuses shortly before Bank of America absorbed that firm. Andrew Clark, *Banking Crisis: Merrill Lynch Top Brass Set to Share $200m*, The Guardian (Sept. 17, 2008) (online at www.guardian.co.uk/business/2008/sep/17/merrilllynch.executivesalaries).

[72] CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics, *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value*, at 9-10 (2006) (online at www.darden.virginia.edu/corporate-ethics/pdf/Short-termism_Report.pdf).

[73] *Id.*

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of the risk of further losses.[74]

A number of common features of executive pay practice that further protect executives against downside risk exacerbate this asymmetry problem. Among these features are the prevalence of option repricing when the underlying company stock falls below the option strike price for sustained periods of time and large severance packages paid to failed executives.

While asymmetries in executive compensation are potentially harmful in the context of any company, they create particular difficulties in the context of regulated financial institutions. Most regulated financial institutions are the beneficiaries of explicit or implicit guarantees. The FDIC insurance system is an explicit guarantee to some depositors, which in the current crisis has been extended to all bank debt. The current Treasury and Federal Reserve rescues of Fannie Mae, Freddie Mac, and AIG, and the recent TARP actions in relation to Citigroup and Bank of America—and perhaps all nine major TARP recipient banks—all raise issues of implicit guarantees. These guarantees provide regulators with an opportunity to ensure that problematically asymmetrical compensation plans do not reappear in these institutions.

***Action item*: Regulators should consider requiring executive pay contracts to provide for clawbacks of bonus compensation for executives of failing institutions.**

Financial system regulators should consider revoking bonus compensation for executives of failing institutions that require federal intervention. Whether the federal government promises to support the institution before a crisis develops, as with Fannie Mae and Freddie Mac, or after, as with TARP recipients, the prospect of losing bonus compensation could deter risky practices that make the federal rescue more probable.

The cases of the Fannie Mae and Freddie Mac seem particularly relevant. In both companies, executive pay in the course of the 1990s moved from a model focused on corporate stability to a model focused on stock price maximization through asymmetric, short-term incentives.[75] It appears that this change fed pressures to increase margins in ways that were only possible by engaging in riskier investment practices.[76] This approach to executive pay is inconsistent with federal guarantees of solvency; inevitably, if it is not abandoned, taxpayers will end up paying for imprudent risk taking by improperly incentivized executives.

As the financial crisis has developed, there has been a fair amount of discussion of clawbacks of executive pay. The Sarbanes-Oxley Act of 2002 required clawbacks of executive pay awarded as a result of fraudulent financial statements.[77] Similar clawback provisions could help restore symmetry and a longer-term perspective to executive compensation systems. As such, regulators should consider adding them to the tools at their disposal.

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[74] Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 139 (2004).

[75] Federal Reserve Bank of St. Louis, William R. Emmons and Gregory E. Sierra, *Executive Compensation at Fannie Mae and Freddie Mac* (Oct. 26, 2004) (Working Paper No. 2004-06) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=678404).

[76] *Id.*

[77] Sarbanes-Oxley Act of 2002, Pub.L. No. 107-204, at § 304.

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***Action item*: Encourage corporate governance structures with stronger board and long-term investor oversight of pay packages.**

The Associated Press recently reported that "even where banks cut back on pay, some executives were left with seven- or eight-figure compensation that most people can only dream about. Richard D. Fairbank, the chairman of Capital One Financial Corp., took a $1 million hit in compensation after his company had a disappointing year, but still got $17 million in stock options. The McLean, Va.-based company received $3.56 billion in bailout money on Nov. 14."[78]

Corporate governance regulations should strengthen the role of boards and long-term shareholders in the executive pay process with the goal of encouraging executive pay practices that align executives' interests with the long-term performance of the businesses they manage

The twin problems of asymmetric and short-term-focused executive pay have been the subject of a number of reform efforts by business groups. Such reform recommendations have come from the Conference Board, in its report on the origins of the financial crisis,[79] and from the Aspen Institute's Principles for Long Term Value Creation,[80] endorsed by the U.S. Chamber of Commerce and the Business Roundtable, as well as by the Council of Institutional Investors and the AFL-CIO.

Financial regulators should encourage these efforts wherever possible and provide assistance wherever practicable.

6. Reform the Credit Rating System

***Problem with current system*: The credit rating system is ineffective and plagued with conflicts of interest.**

The major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk. In the subprime-related market specifically, high ratings for structured financial products—especially mortgage-backed securities (MBS), collateralized debt obligations (CDO), and CDOs that invested in other CDOs (frequently referred to as CDO-squared, or CDO^2)—were essential for ensuring broad demand for these products. High ratings not only instilled confidence in potentially risk-averse investors, but also helped satisfy investors' regulatory requirements, which were often explicitly linked to ratings from the major credit rating agencies. By 2006, Moody's business in rating structured financial products accounted for 44 percent of its revenues, as compared to 32 percent from its traditional corporate-bond rating business.[81] It has also been reported that "roughly 60 percent of all global structured products were AAA-rated, in contrast

[78] Frank Bass and Rita Beamish, *Study: $1.6B of Bailout Funds Given to Bank Execs*, Associated Press (Dec. 21, 2008).

[79] Conference Board, Linda Barrington, Ellen S. Hexter, and Charles Mitchell, *CEO Challenge 2008: Top 10 Challenges—Financial Crisis Edition* (Nov. 2008) (online at www.conference-board.org/publications/describe.cfm?id=1569).

[80] Aspen Institute, *Long-Term Value Creation: Guiding Principles for Corporations and Investors* (2008).

[81] Harvard Business School, Joshua D. Coval, Jakib Jurek, and Erik Stafford, *The Economics of Structured Finance*, at 4 (2008) (Working Paper No. 09-060) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=1287363).

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to less than 1 percent of corporate issues."[82] Financial firms, from Fannie Mae to AIG, also benefited greatly from having high credit ratings of their own—especially AAA—allowing them not only to borrow at low rates on the short-term markets to finance longer-term (and higher yielding) investments but also to sell guaranties of various sorts, effectively "renting out" their credit rating.

Numerous explanations have been offered for credit rating agencies' apparent mistakes, including conflicts of interest, misuse of complex models, and their quasi-public status as nationally recognized statistical rating organizations (NRSROs).

Regarding conflicts of interests, worrisome is the rating agencies' practice of charging issuers for their ratings, a practice that began at Fitch and Moody's in 1970 and at Standard & Poor's a few years later.[83] Although the practice of collecting payments from issuers has long provoked criticism, market observers often downplayed these concerns, suggesting that "the agencies have an overriding incentive to maintain a reputation for high-quality, accurate ratings."[84] Others, however, claim that the "issuer pays" model biases ratings upward and also encourages "ratings shopping" by issuers, which in turn provokes a race to the bottom on the part of the rating agencies, each willing to lower quality standards to drum up more business.[85]

Beyond the ratings themselves, credit rating agencies also charge issuers for advice, including pre-rating assessments (in which issuers learn what ratings will likely be under various hypothetical scenarios) and risk-management consulting. In some cases, credit rating agency analysts subsequently go to work for the companies they had been rating.[86] This revolving-door practice creates not only the potential for conflicts of interest but also for gaming of the system, since former employees of the rating agencies presumably know how best to exploit weaknesses in the agencies' risk assessment models.

Many critics charge that it was the models themselves—and overreliance on them—that got the credit rating agencies into trouble in recent years, particularly in assigning ratings to structured financial products. "Instead of focusing on actual diligence of the risks involved, demanding additional issuer disclosures, or scrutinizing collateral appraisers' assessments," writes one skeptic, "rating agencies primarily relied on mathematical models that estimated the loss distribution and simulated the cash flows of RMBS [residential mortgage backed securities] and CDOs using historical data."[87]

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[82] *Id.*

[83] Richard Cantor and Frank Packer, *The Credit Rating Industry*, FRBNY Quarterly Review, at 4 (Summer–Fall 1994). *See also* Claire Hill, *Regulating the Rating Agencies*, Washington University Law Quarterly, at 50 (2004).

[84] Cantor and Packer, *supra* note 81, at 4.

[85] House Committee on Oversight and Government Reform, Testimony of Jerome S. Fons, *Credit Rating Agencies and the Financial Crisis*, 110th Cong., at 3 (Oct. 22, 2008) (online at oversight.house.gov/documents/20081022102726.pdf).

[86] John P. Hunt, *Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, Columbia Business Law Review, at 32-33 (2009) (papers.ssrn.com/sol3/papers.cfm?abstract_id=1267625).

[87] Jeffrey David Manns, *Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating*

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Many of the models involved excessively rosy assumptions about the quality of the underlying mortgages, ignoring the fact that these mortgages (especially subprime mortgages) were far riskier than ever before and were in fact becoming steadily riskier year by year.[88] Credit rating agency modeling of mortgage-related securities may also have involved mistaken assumptions about the independence of the underlying mortgages—including the assumption that defaults would not be highly correlated across a broad bundle of mortgages or mortgage-related securities.[89] By extension, many of the rating agencies' models may also have involved overly optimistic assumptions about the direction of housing prices (that is, that they would not fall by much, if at all). When asked on a conference call in March 2007 about how a 1 to 2 percent decline in home prices over an extended period of time would affect Fitch's modeling of certain subprime-related securities, a Fitch representative conceded, "The models would break down completely."[90]

Yet another problem plaguing the rating agencies' models was the practice of embedded structuring by issuers, according to which CDOs would themselves become inputs into new CDOs (CDO^2). "With multiple rounds of structuring," three finance professors explain, "even minute errors at the level of the underlying securities, which would be insufficient to alter the security's rating, can dramatically alter the ratings of the structured finance securities."[91]

Of particular concern from a regulatory standpoint is the extent to which state and federal (and even global) financial regulations are linked to private credit ratings—and, in fact, to ratings issued by just a handful of specially designated credit rating agencies, the NRSROs). To the extent that leading credit rating agencies enjoy a protected status and virtually guaranteed demand as a result of their regulatory significance, they may face diminished incentives to maintain the quality of their ratings.

The SEC has recently undertaken a number of reforms aimed at the operations of the NRSROs pursuant to the passage of the Credit Rating Agency Reform Act of 2006 (the Rating Agency Act),[92]

Agency Accountability, North Carolina Law Review (forthcoming), at 32–33 (papers.ssrn.com/sol3/papers.cfm?abstract_id=1199622) (accessed Jan. 4, 2009).

[88] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies,* at 33 (July 2008) (online at www.sec.gov/news/studies/2008/craexamination070808.pdf) (hereinafter "Summary Report") ("In addition to the recent growth in subprime origination, there has also been a growth in the risk factors associated with subprime mortgages. Studies indicate that the percentage of subprime loans with less-than-full documentation, high combined loan to total value (CLTVs), and second liens grew substantially between 1999 and 2006. Notably, while 2/28 adjustable rate mortgages comprised just 31 percent of subprime mortgages in 1999, they comprised almost 69 percent of subprime loans in 2006. Further, 40-year mortgages were virtually non-existent prior to 2005, but they made up almost 27 percent of the subprime loans in 2006. These data provide evidence that the majority of subprime origination occurred within the last five years, and the loans containing very high risk combinations are even more recent."). The SEC report also documented that, at one major credit rating agency, "the average percentage of subprime RMBS in the collateral pools of CDOs it rated grew from 43.3 percent in 2003 to 71.3 percent in 2006." *Id.* at 7. Given these dramatic changes in the mortgage market, basing models on historical mortgage data may have proved particularly problematic.

[89] Indeed, a significant degree of independence was essential, since "CDOs rely on the power of diversification to achieve credit enhancement." Coval, et al., *supra* note 81, at 10.

[90] *See id.* at 23.

[91] *Id.* at 10.

[92] Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291.

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which granted the SEC authority to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. Before this grant of authority to the SEC, NRSROs were essentially unregulated. Pursuant to its new regulatory authority, the SEC has registered ten firms;[93] instituted examinations of NRSROs' practices;[94] and proposed rules designed to enhance accountability, transparency, and competition.[95] The Rating Agency Act and the SEC's recent regulatory activity are positive developments. However, since 2006 the financial crisis has revealed the extent of the harmful consequences of the deep-seated conflicts of interest and distorted incentives associated with the credit ratings firms. With the knowledge that the contours of reform of credit rating agency regulation must take into account the SEC's actions, we propose the following recommendations.

***Action item*: Adopt one or more regulatory options to address conflicts of interest and incentives.**

To address conflicts of interest, the SEC or a new regulatory body (see below) could impose limits on the proportion of revenues of rating agencies that are derived from issuers, though there is disagreement about whether alternative revenue sources would prove sufficient.[96] Alternatively, for each rating, issuers could be required to pay into a pool, from which a rating agency would be chosen at random.[97] Here, the challenge would be to maintain the quality of ratings after severing the link between pay and performance. One could also imagine the introduction of grace periods in which credit rating analysts could not take jobs with their clients. While this too would limit conflicts of interest, it might also interfere with the recruiting of high-quality credit analysts at the rating agencies.

To improve incentives, the SEC or some other regulatory body should further encourage additional competition by progressively expanding the ranks of the NRSROs.[98] Other options would include additional disclosure requirements or prohibitions on rating agencies' use of nonpublic information.[99] Since rating agencies currently face little if any legal liability for malfeasance in the production of ratings, a number of experts have proposed strategies for imposing liability on credit

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[93] U.S. Securities Exchange Commission, *Nationally Recognized Statistical Rating Organizations* (online at www.sec.gov/divisions/marketreg/ratingagency.htm) (accessed Jan. 26, 2008) (hereinafter "SEC NRSRO Web site"). These ten include the old line firms Moody's, Standard & Poor's, and Fitch. *Id.*

[94] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Christopher Cox, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies,* 110th Cong. (Apr. 22, 2008) (online at www.sec.gov/news/testimony/2008/ts042208cc.htm).

[95] SEC NRSRO Web site, *supra* note 93.

[96] House Committee on Oversight and Government Reform, Testimony of Sean J. Egan, *Credit Rating Agencies and the Financial Crisis*, 110th Cong., at 9 (Oct. 22, 2008) (online at oversight.house.gov/documents/20081022102906.pdf).

[97] David G. Raboy, *Concept Paper on Credit Rating Agency Incentives* (Jan. 9, 2009) (unpublished working paper on file with the Panel).

[98] Hill, *supra* note 83, at 86–87.

[99] Egan, *supra* note 96, at 8.

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rating agencies to ensure appropriate accountability.[100] Although such reforms might well prove helpful, they would be unlikely to solve the underlying problem by themselves.

***Action item*: Reform the quasi-public role of NRSRO's and consider creating a Credit Rating Review Board.**

Perhaps the most pressing issue of all from a regulatory standpoint is the NRSRO designation itself. Particularly given all of the concerns that have been raised about the credit rating agencies and their poor performance leading up to the current crisis, state and federal policymakers will need to reassess whether they can continue to rely on these private ratings as a pillar of public financial regulation.[101] In fact, it may be time to consider the possibility of eliminating, or at least dramatically scaling back, the NRSRO designation and replacing it with something else.[102]

One option would be to create a public entity—a Credit Rating Review Board—that would have to sign off on any rating before it took on regulatory significance. Even if an asset was rated as investment grade by a credit rating agency, it could still not be added to a bank or pension fund portfolio, for example, unless the rating was also approved by the review board. Ideally, the board would be given direction by lawmakers to favor simpler (plain vanilla) instruments with relatively long track records. New and untested instruments might not make the cut. Of course, such new instruments could still be actively bought and sold in the private marketplace. Only regulated transactions that currently require ratings would be effected. Two key advantages of this approach are that it would permit a dramatic opening of the market for private credit ratings and at the same time discontinue the unsuccessful outsourcing of vital regulatory monitoring.

Another, substantially different, option for the design of such a Credit Rating Review Board would be to model the board in part on the Public Company Accounting Oversight Board (PCAOB), a nont-for-profit corporation that was created by the Sarbanes-Oxley Act to oversee the auditors of public companies.[103] Under this model, the Credit Rating Review Board would not rate instruments ex ante, but instead audit ratings after the fact, perhaps on an annual basis, to ensure that rating agencies are sufficiently disclosing their rating methodologies, the ratings agencies' methodologies are sound, and the rating agencies are adhering to their methodologies. Depending on the course of the SEC's rulemaking, the Credit Rating Review Board could coordinate with or assume some of the SEC's authority to regulate conflicts of interest and inspect, investigate, and discipline NRSROs.

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[100] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Frank Partnoy, *Assessing the Current Oversight and Operation of Credit Rating Agencies*, 109th Cong., at 5 (Mar. 7, 2006) (online at banking.senate.gov/public/_files/partnoy.pdf).

[101] A recent SEC report acknowledged, "The rating agencies' performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole." Summary Report, *supra* note 88, at 2).

[102] Frank Partnoy has suggested linking regulation instead to market-based measures of risk, such as credit spreads or the prices of credit default swaps. Partnoy, *supra* note 100, at 80–81.

[103] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, at §§ 101–109.

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7. Make Establishing a Global Financial Regulatory Floor a U.S. Diplomatic Priority

***Problem with current system*: The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that increase market risk.**

The rapid globalization of financial markets in recent decades has created a new set of problems for national regulators and exposed market participants to an additional element of risk. Capital is able to flow freely across international borders, while regulatory controls are bound to domestic jurisdictions. Private actors, therefore, have the benefit of seeking out regulatory climates that best accommodate their financial objectives. Countries, in turn, bid for capital flows by adjusting their tax and regulatory schemes, as well as their legal infrastructure and employment laws. While New York and London tout their preeminence as financial capitals, Tokyo, Hong Kong, Singapore, Bahrain, and Doha, Qatar have all become financial hubs. At the same time, certain offshore tax havens, such as the Cayman Islands, the Bahamas, and the Channel Islands have developed local industries catering to the financial services needs of foreigners. Often, the sole comparative advantage offered by these locations is the opportunity to profit from "regulatory arbitrage." The consequence is a global race to the bottom whereby deregulation is pursued to the detriment of market stability.

Meanwhile, global markets have become increasingly interconnected. From 1990 to 2000, the total dollar amount of crossborder securities holdings where non-U.S. investors held U.S. securities, or vice versa, grew from approximately $1.5 trillion to approximately $6.9 trillion.[104] Today, U.S. issuers raise debt and equity funding in local markets all over the world. Conversely, foreign issuers who previously looked to the liquidity of the United States capital markets now find equally liquid pools of capital in Europe and Asia.

When financial turmoil strikes issuers or borrowers in one country, it is equally likely to have adverse consequences beyond national borders. The subprime mortgage crisis of 2008 caused widespread havoc outside the United States, beginning with a small thrift in England and sweeping over the world. At the same time the United States government initiated its $700 billion bailout plan, the United Kingdom established a facility to make additional capital available to eight of its largest banks and building societies, the governments of France, Belgium, Luxembourg and the Netherlands made large capital infusions to bail out major banks operating in those countries, and the government of Iceland was forced to take over the three largest banks there.[105] Stock markets worldwide plunged. Investors large and small suffered.

The abiding lesson is that booms and busts can no longer be restricted to their country of origin. Nations must embark on aggressive diplomatic efforts to address the collective risks posed by today's globalized financial markets.

***Action item*: Build alliances with foreign partners to create a global financial regulatory floor.**

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[104] Securities Industry Association, *Securities Industry Fact Book*, at 80 (2002) (online at www.sifma.org/research/statistics/other/2002Fact_Book.pdf).

[105] Steven Erlanger and Katrin Bennhold, *Governments on Both Sides of the Atlantic Push to Get Banks to Lend*, New York Times (Nov. 6, 2008).

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Given the ease with which money moves across international borders, it is difficult for one country to adopt a system to provide adequate regulation of the capital markets, as well as adequate consumer protection, unless all major participants in the global economy have agreed to coordinated action beforehand. Otherwise, regulatory arbitrage and the resulting race to the bottom are inevitable. To assure the stability of the markets, it is therefore imperative for U.S. financial market regulators, as well as the State Department, to work together to encourage greater harmonization of regulatory standards, as well as broad adoption of a floor of recognized "prudent regulatory measures."

Better coordination of regulation and surveillance, while difficult to achieve, will result in better-regulated entities that are less likely to cause damages to global markets and other market participants. It is also likely to result in more efficient and less costly regulation for regulated entities.

***Action item*: Actively participate in international organizations that are designed to strengthen communication and cooperation among national regulators.**

Financial services regulators have created a number of organizations to share ideas and information regarding financial services entities and markets. These include the Basel Committee on Bank Supervision (BCBS), the Senior Supervisors Group (SSG), and the International Organization of Securities Commissions (IOSCO). The SSG, for one, meets regularly to discuss supervisory matters and to issue recommendations for better supervision.[106]

The SSG also periodically sponsor "colleges of supervisors," in which supervisors from several countries that have jurisdiction over part of the operations of a globally active financial services firm will convene to discuss issues regarding regulation of the firm. Established linkages between regulators with different perspectives on a particular entity facilitate information-sharing that enables all supervisors to better understand the risks facing the entity. These relationships also ensure better coordination during times of stress. These efforts should be expanded to include consideration of systemically important financial institutions, in order to develop a better understanding of the risk profiles of such institutions and to improve their ability to intervene where the risk profile increases to potentially destabilizing levels.

8. Plan for the Next Crisis

***Problem with current system*: Participants, observers, and regulators neither predicted nor developed contingency plans to address the current crisis.**

Despite calls for caution from some quarters, very few observers predicted the severity of the current collapse in the housing, debt, and equity markets, or the massive decline in economic activity. Those commentators who most vocally raised doubts about the sustainability of housing prices, the pace of derivatives growth, or lax regulation were largely dismissed as fearmongers, or as simply "not getting it."[107]

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[106] Senior Supervisors Group, *Observations on Risk Management Practices in the Recent Market Turbulence* (Mar. 6, 2008) (online at www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf).

[107] *See, e.g., Meet Dr. Doom*, IMF Survey, at 308 (Oct. 16, 2006) (online at www.imf.org/EXTERNAL/PUBS/FT/SURVEY/2006/101606.pdf).

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Traditional measures of financial and economic exposure, such as bank capitalization, troubled loans, stock prices, and money supply growth, indicated only moderate exposure to a sharp asset price collapse and a severe recession.[108] Yet there was a compelling case for concern based on a closer examination of the multiple layers of leverage invested in housing assets and their derivatives.[109] More broadly, stagnant household productivity, the pace of financial product innovation and the increased leverage on Wall Street might all have set off alarm bells.[110]

Indeed, some analysts see systemic collapses as inherently more likely in complex, interdependent systems such as our modern financial environment.[111] While most destructive outcomes are deemed to be so unlikely, based on historical comparisons, that they are not worth considering, recent analysis indicates on the contrary that complex systems produce these "outlier" results on a counterintuitively regular basis.[112]

Current institutions are not likely to fare better in the future. Governments, industry, Wall Street, and academia typically employ economists with similar training and backgrounds to create their forecasts, leading to procyclical optimism and convergence of economic forecasts. In particular, economists have a truly dismal record in predicting the onset of recessions and asset crashes.[113] Given the risk of a similar collapse in the future and the lack of formal processes in business or government requiring that the truly dismal scenarios be assessed, the current system will likely face similar risks not long after the present crisis is resolved.

***Action item*: Create Financial Risk Council of outside experts to report to Congress and regulators on possible looming challenges.**

To promote better planning, financial experts should be aiming to identify the problems of the future, much as the military does. To this end, the Panel recommends establishing a Financial Risk Council featuring a truly diverse group of opinions, a formal mechanism whereby the concerns, both individual and collective, of this group will be regularly brought to the attention of Congress and financial regulators, with a focus on precisely those low-likelihood, huge-magnitude developments that consensus opinion will dismiss.

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[108] *See, e.g., id.*

[109] Government Accountability Office, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,* at 16–23 (2009). (online at www.gao.gov/new.items/d09216.pdf) (discussing overleveraging and financial interconnectedness as contributing to a risky financial environment immediately preceding the current crisis).

[110] *Id.*

[111] *Id.* at 18–19.

[112] *See, e.g.,* Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (2007); Daniel G. Goldstein and Nassim Nicholas Taleb, *We Don't Quite Know What We Are Talking About When We Talk About Volatility* (Mar. 28, 2007) (online at ssrn.com/abstract=970480).

[113] Even where outside advisory groups have been set up to counsel the Government regularly on economic issues, as the Conseil d'Analyse Economique (CAE) does in France, there is a marked similarity of backgrounds among their membership. Conseil d'Analyse Économique, *Membres du Conseil* (online at www.cae.premier-ministre.gouv.fr) (accessed Jan. 26, 2009). This may help explain why these bodies did not produce even minority viewpoints warning of the current financial crash; CAE did not produce a report on the subprime mortgage crisis until September, 2008. Conseil d'Analyse Économique, *Rapports du Conseil d'analyse économique* (online at www.cae.premier-ministre.gouv.fr) (accessed Jan. 26, 2009).

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The council should consider all potential domestic and foreign threats to the stability of the U.S. financial systems. These sources of threat should include, but not be limited to: (1) economic shocks and recessions; (2) asset booms and busts; (3) fiscal, trade, foreign exchange, and monetary imbalances; (4) infrastructure failures, natural disaster, and epidemics; (5) institutional mismanagement; (6) crime, fraud; and terrorism; (7) legislative and regulatory failure; and (8) failed product and process innovation.

Strong, independent thinking among the membership of the Council will be critical: every effort should be made to avoid an optimistic consensus that there are no major threats looming. To that end, Council members should represent a diverse array of stakeholders, with a record of speaking their minds.

The council would be required to publish regular reports to Congress and to select among various techniques for identifying threats. These approaches might include:

1. Wargaming: Teams represent various market, government, regulatory, and subversive constituents. A control team sets up the initial environment and introduces destabilizing changes. The teams respond in real time and the control group feeds the impacts of their decisions into the environment. Subsequent to the wargame, there is an examination of outcomes, the level of constituent preparedness, and the quality of the risk management processes.
2. Strategic scenario analysis: An analytic team works backward from worst-case financial crisis outcomes to identify the potential triggering factors and preventative or mitigating solutions. This approach prevents the "it couldn't happen" mindset.
3. Nonlinear modeling/"black swan" sensitivity analysis: An analytic team assumes previously unseen levels for key variables in order to destabilize financial models and observes break points and systemic failures.

A Financial Risk Council composed of strong, divergent voices should avoid overly optimistic consensus and conventional wisdom, keeping Congress appropriately concerned and energized about known and unknown risks in a complex, highly interactive environment.

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V. Issues Requiring Further Study

There are several important questions regarding financial regulatory reform that are beyond the scope of this Report, and will require further attention.

First, the Panel has identified three highly technical issues relating to the financial regulatory system, and recommends that the relevant regulatory agencies take up specialized review of these questions. These are:

1. *Accounting rules*: Further study is required to identify needed reforms of the current accounting rules, particularly with connection to systemic risk. Among the issues that should be considered are mark-to-market accounting, mark-to-model accounting, fair-value accounting, issues of procyclicality, accounting for contingent liabilities, and off-balance-sheet items.
2. *Securitization*: Further study is required to consider the logic and limits of securitization, and reform options such as requiring issuers to retain a portion of offering, phased compensation based on loan or pool performance, and other requirements.
3. *Short-selling*: In light of recent imposed limits, regulation of short-selling should be further studied and long-term policies should be developed.

Second, the Panel plans to address regulatory architecture more thoroughly in a subsequent report, including the issues of co-regulation, universal banking, regulatory capture, the revolving door problem, bankruptcy and receivership issues involving financial institutions, and the division of regulatory responsibilities.

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VI. Acknowledgments

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The Panel is also grateful to the following individuals who generously provided their time and expertise to the preparation of this report: Tobias Adrian, Professor Edward Balleisen, Dean Baker, Brandon Becker, Pervenche Beres, Professor Bruce Carruthers, Professor Lord Eatwell, Douglas Engmann, former Senator Phil Gramm, Professor Michael Greenberger, Professor Joseph Grundfest, Michael Jamroz, Robert Kelly, Professor Naomi Lamoreaux, Professor Stan Liebowitz, Professor Andrew Lo, David Raboy, Professor Hal Scott, L.W. Seidman, Professor Jay Westbrook, Professor Luigi Zingales, Professor Todd Zywicki, and the Squam Lake Working Group on Financial Regulation (including Martin Baily, Andrew Bernard, John Campbell, John Cochrane, Doug Diamond, Darrell Duffie, Ken French, Anil Kashyap, Rick Mishkin, Raghu Rajan, David Scharfstein, Matt Slaughter, Bob Shiller, Hyun Song Shin, Jeremy Stein, and Rene Stulz). The Panel thanks the following institutions and organizations for their contributions: Business Roundtable (including John Castellani and Tom Lehner), the Chicago Board Options Exchange, the Financial Industry Regulatory Authority, the Council of Institutional Investors (including Anne Yerger, Amy Borrus, and Jeff Mahoney), the Consumer Federation of America (and Barbara Roper), the International Swaps and Derivatives Association (and Robert Pickel), and the National Consumer Law Center (including Lauren Saunders and Margot Saunders). The Panel also benefited from the guidance of David Einhorn, Sarah Kelsey, Arthur Levitt, Alex Pollock, Professor Robert Merton, and Lawrence Uhlick.

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VII. About the Congressional Oversight Panel

In response to the escalating crisis, on October 3, 2008, Congress provided the U.S. Department of the Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stabilization (OFS) within Treasury to implement a Troubled Asset Relief Program (TARP). At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress has instructed the Panel to produce a special report on regulatory reform that will analyze "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers."

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School to the Panel. With the appointment on November 19 of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel, completing the Panel's membership.

Congressman Hensarling and former Senator Sununu did not approve this report. Their alternative view is included in the following section.

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VIII. Additional Views

Richard H. Neiman

I am pleased to support the Panel's special report on regulatory reform, which begins to address some of the most critical issues facing our nation, such as improving consumer protection, reducing systemic risk, eliminating regulatory gaps, and enhancing global co-ordination of supervision. These are precisely the issues we need to address in these unprecedented times, when Americans are losing their homes, and the financial system and our economy are at greater risk than at any time since the Depression.

Addressing any one of these issues individually would be a challenge; compiling a report that addresses them all within nine short weeks was a herculean task. Given the diversity of backgrounds and ideological views of the panel members, the fact that we have reached agreement on the critical issues and on many action items to address those issues is truly remarkable.

As the only regulator on the panel, I find it appropriate to highlight certain issues of particular importance and to which I bring a unique perspective.

- STATES MUST BE ALLOWED TO INCREASE THEIR ROLE IN PROTECTING CONSUMERS

States have long strived to protect their citizens from harmful financial products and should continue to carry out this vital role. States, like New York, sounded an early alarm on subprime lending by adopting anti-predatory lending legislation and reaching landmark settlements with the nation's top mortgage bankers, providing hundreds of millions of dollars in consumer restitution and improving industry practices.

Rather than join with the states, however, the OCC and the OTS thwarted state efforts, by claiming broad field preemption and then failing to adopt measures that protected consumers. This federal overreach caused gaps in consumer protection standards, as more protective state laws were set aside without being replaced by appropriate national standards or equivalent enforcement efforts.

I want to underscore the Panel's recommendation to eliminate federal preemption of state consumer laws and confirm the ability of states to examine and enforce compliance with federal and state consumer protection laws. The recommendations will restore the appropriate balance between federal and state regulators and provide the basis for a "New Federalism." It will draw on what is best about our current dual banking system, close gaps in consumer protection, and maximize the effectiveness of the joint resources of state and federal regulators.

- THE FEDERAL RESERVE BOARD SHOULD SET MINIMUM FEDERAL STANDARDS FOR CONSUMER PROTECTION

The Panel's report calls for the establishment of a single federal regulator that would have overarching consumer protection responsibilities, such as setting national minimum standards. We need to establish adequate baseline consumer protections for all Americans. Under this proposal, states could adopt more stringent requirements than the federal body, as local conditions warranted,

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and could regulate consumer protection standards in the absence of federal action. This would allow states to serve as incubators to develop innovative regulatory solutions. Laws that are tried first at the state level and found successful often serve as the model for laws at the national level.

The national minimum standards should go beyond required disclosures and extend to substantive regulation of consumer financial products. Disclosure alone does not address the issues that gave rise to the current crisis. We need to address key issues, including affordability, suitability, and the duty of care owed by financial services providers to consumers.

While I wholeheartedly support a heightened emphasis on consumer issues, I believe the functions of consumer protection should not be separated from the role of safety and soundness. Loans that take unfair advantage of consumers adversely affect the safety and soundness of financial institutions. Regulators must consider an institution's activities holistically, to detect emerging problems and have adequate tools to respond. Too narrow a mission could lead to myopic, impractical regulations, increasing the likelihood of negative unintended consequences and threatening to undermine the safety and soundness of financial institutions. Assigning the consumer protection function to a new stand-alone agency with a limited mandate would create yet another federal bureaucracy, at a time when I believe we need to be streamlining and avoiding counter-productive regulatory turf wars.

I recognize that the Federal Reserve Board may have been slow to take up consumer protection responsibilities placed on it by Congress. However, I believe that the current crisis has demonstrated to the Fed the importance of consumer protection to the health of our financial institutions and the economy as a whole.

- THE FEDERAL RESERVE BOARD SHOULD BE THE SYSTEMIC REGULATOR

The Panel's report correctly identifies the need for a federal systemic risk regulator, and I concur with proposals, such as those by the Group of Thirty, that this role be performed by a country's central bank.

The current crisis has demonstrated that the Federal Reserve Board, our nation's central bank, is ideally suited to harness the tools available to it to address systemic risk. The Fed has played a pivotal role in designing and implementing solutions to the current financial crisis and has gained unparalleled insight into risks presented by non-banking as well as banking institutions. However, the Fed still has no explicit authority over many non-banking organizations that meet the definition for being "systemically significant." The Fed's function in setting monetary policy, as well as supervising banking organizations and providing discount window facilities, strategically places it at the heart of the nation's regulatory nerve center. Creating new agencies to perform these broader systemic tasks would needlessly duplicate existing functions, dilute current levels of expertise and fail to take advantage of the wealth of experience accumulated by the Fed. The Federal Reserve's mission could easily be updated to formally incorporate these tasks into a broader mandate. I am confident that result would be a healthier, more vibrant financial system.

- WE NEED TO RESTORE THE CONFIDENCE OF THE AMERICAN PUBLIC

As the Panel's report states, we need to restore a proper balance between free markets and the

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regulatory framework, in order to ensure that those markets operate to protect the economy, honest market participants and the public. I look forward to working with Congress to address the issues the report identifies, so that we can restore the confidence of the American public in the financial services system.

Congressman Jeb Hensarling and former Senator John E. Sununu

Preface

As part of the Economic Emergency Stabilization Act of 2008 (Pub. L. No. 110-343), Congress required that the newly established Congressional Oversight Panel (the Panel) prepare a report "analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the rationale underlying such recommendation, and whether there are any gaps in existing consumer protections." Even in an environment where dozens of organizations have already offered their own perspective on the economic crisis and regulatory reform, assembling such a document in the short time the Panel has been in operation would be a daunting task. Adding to the challenge, the Panel is a diverse group which possessed a dedicated, but minimal staff well into the middle of January. As a result, much of the work drafting the Panel Report was given to individuals outside its operation.

Building consensus over such a broad range of economic questions would be difficult in any event. The timing and process for preparing this document, unfortunately, made it more so. Given the differences that remain regarding our views of the systemic weaknesses that led to the crisis, and, more important, policy recommendations for reform, we have chosen not to support the Panel Report as presented. Instead, we provide here a more concise statement of the underlying causes of the current financial crisis and a series of recommendations for regulatory modernization. While there are several points in the Panel Report with which we agree, we also provide a summary of several areas where our disagreement led us to oppose the final product.

This statement is organized into several sections:

1. Introduction
2. Observations on Current State of Financial Regulation
3. Underlying Causes of the Credit Crisis
4. Recommendations for Financial Service Regulatory Modernization and Reform
5. Differences with Congressional Oversight Panel Recommendations

In preparing this summary, we drew heavily from several sources, which presented a range of views, but in which we also shared many common themes and recommendations. These include the Group of 30's *Financial Reform: A Framework for Financial Stability*, the Committee on Capital Markets Regulation's *Recommendations for Reorganizing the U.S. Financial Regulatory Structure*, the GAO's *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, and the Department of the Treasury's *Blueprint for a Modernized*

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Financial Regulatory Structure. Others playing an influential role in helping frame the often complicated policy questions engendered by this work include the scholars at the American Enterprise Institute (AEI), particularly Peter Wallison and Alex Pollock, as well as those at George Mason University's Mercatus Center, including Professor Todd Zywicki, Houman B. Shadab, and Satya Thallam.

If one theme emerged among others in these differing perspectives on the challenges ahead, it is that our pursuit should not be simply to identify new rules or areas in which to regulate, but to build a structure and system that is modern and appropriate to the institutions and technologies being used every day. A well-designed system should enhance market discipline, minimize risks to taxpayers, and avoid the pitfalls of unintended consequences. We hope our recommendations are true to these objectives.

Introduction

Since the collapse and rescue of Bear Stearns in March 2008, legislators, regulators, and financial market participants have found themselves enmeshed in a discussion of whether the financial system needs to be saved, and, if so, how best to save it. In October 2008, Congress passed the Emergency Economic Stabilization Act (EESA), which made available $700 billion for the purpose of purchasing mortgage-backed securities from financial institutions in hope of stabilizing the financial system. Shortly after Congress voted to make these funds available, the Treasury Department changed course and instead decided to purchase capital in the nation's financial institutions to free up credit markets.

Recent events—including additional losses by the nation's financial institutions, new Treasury programs to support two of the country's largest financial firms, and reports that the sums spent thus far on recapitalizing financial institutions have had only modest impact—demonstrate that while identifying problems in a marketplace might be easy, the task of isolating those problems, diagnosing their cause, and discerning how best to address them remains challenging. The conversation over how best to revive the financial system continues, and despite its urgency, it is essential that the participants in that conversation not rush to act in pursuit of a plan that fails to solve the problems we face, or makes them worse.

Beyond the pressing challenges to stabilize our economic system, however, is the broader question of how best to oversee our financial system. If reorganization is to be done responsibly, it will demand an extraordinary amount of study, research, thought, and discussion, beginning with a careful, unbiased consideration of what exactly led to the crisis that now threatens our financial system. The observations and recommendations contained in these views should therefore be viewed as a preliminary contribution to the debate, not the final word. If not for reasons of modesty, then for reasons of prudence and responsibility, readers should be cautioned that this represents the opening round of a longer conversation regarding the future of our financial system.

While the rapid escalation of the credit crisis last fall forced Congress to forgo a more deliberative process in considering policy options to respond, it is widely acknowledged now by both proponents and opponents of congressional action that properly addressing this crisis will involve a more carefully crafted response than the broadly defined powers given to Treasury under the $700 billion EESA. The stakes are no less important in regulating our financial system, for the consequences of mistakes made in rushing to fix a problem not fully understood will sow the seeds

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of even greater problems in the future.

As a precursor for constructive reform, policy makers must first avoid a reflexive urge to simply write new rules. In the wake of the largest financial crisis since the Great Depression, some have called immediately to "reregulate" the financial system to prevent calamities like this from occurring again. Those that believe that regulation is the only answer, however, ignore the significant ways in which government intervention magnified our existing problems. In fact, there are few, if any, segments of the economy in which government regulates, intervenes, and legislates as heavily as it does in the financial and housing sectors. Before embracing more government regulation as the only answer, such advocates should consider the many ways in which government regulation itself can be part of the problem. The history of financial regulation is replete with such examples as either regulators or regulation have simply failed or made matters worse.

In fact, the hallmark of past efforts to regulate the financial system has been that government regulation frequently fails. History has also repeatedly shown us that adding rigid new government regulations in the midst of a crisis to solve existing problems may be like the old military adage of armies being prepared to fight the last war. For example:

1. For decades, banking regulators tried to fix deposit prices nationally through "Regulation Q," which effectively denied savers significant amounts of interest and, in turn, imperiled thrifts and banks as deposits fled when interest rates were high. As with all government regulation, Reg Q was grounded in the belief that government mandates could manage market forces and keep banks safer.
2. Twenty years ago, in response to the failure of 1,600 commercial banks in the savings and loan crisis, the federal government enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub..L. No. 102-242) (FDICIA), which significantly tightened bank and S&L regulation in an attempt to generate stability. However, the tougher restrictions of FDICIA did not fix the problem, and the savings and loan crisis ended up costing American taxpayers over $120 billion.[114]
3. More recently, state and federal legislation mandated the use of credit ratings from a few rating agencies, which effectively transformed these agencies into a government-sponsored cartel. What began as an impulse to bring safety and objectivity to the regulation of broker-dealers ended by creating a concentrated point of failure, jeopardizing the entire financial system.
4. Finally, there is the example of the Federal Reserve's effort to use monetary policy to avoid the recessionary effects of the tech bubble's bursting, only to find that in doing so, it had helped create the housing bubble.

In addition to its demonstrated failure in preventing financial collapse, regulation imposes significant costs on the financial system in several ways. For example, rather than increasing stability and enhancing safety, regulation can invite chaos and encourage otherwise irrational risk taking among market participants who falsely believe that government will act as a guardian angel to protect them. Market participants thus underprice risk because they conjecture government has managed the risks that market participants would otherwise have had to assess. However, in reality,

[114] Timothy Curry and Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC Banking Review (December 2000) (online at www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf).

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any government—from our current one to the most heavy-handed of all totalitarian central planners—can never completely regulate a market given its resource constraints and the ingenuity of individual entrepreneurs with a proper profit motive.

Regulation can also reduce competition because its costs are more easily borne by large companies than by small ones. Large companies also have the ability to influence regulators to adopt regulations that favor their operations over those of smaller competitors. This is particularly true when regulations add costs that smaller companies cannot bear. Take, for example, the continuing decline in the number of community banks, the locally owned and operated institutions at the heart of many small towns and cities across the county. In 2004, the Federal Deposit Insurance Corporation (FDIC) released a report on the future of banking that found that although community banks still make up a majority of the banking industry, the number of community banks had been cut almost in half since 1985. The report also found that their deposit share has also declined significantly in that time frame as large banks extended their geographic reach.[115] Regulation also may keep low cost producers or international competitors out of regulated markets.

Regulation can also harm consumers in the form of higher costs, less innovation, and fewer choices. Regulatory costs are passed along to consumers through higher prices for services or products. For an example, one need only look at their monthly telephone bill to see firsthand how the cost of various government regulations imposed on phone services are directly passed onto consumers in the form of new fees. Since the application of regulations over a population is generally universal but the direct benefits are often only individually realized, many regulations end up imposing costs on all consumers for the benefit of a limited few. Additionally, the associated cost of some regulations end up exceeding their value by adding costs to the process of developing new products or new services. There are countless examples of this phenomenon in the insurance industry, where it can take years to achieve the regulatory approval needed to roll out a new product offering or, in some bewildering cases, to enact rate reductions for the benefit of consumers if the reduction is approved at all.[116]

Instead of creating new regulatory hurdles, a superior approach to better protect consumers and preserve wealth-creating opportunities is to enhance and reinforce wise regulation while bolstering private sector market discipline. This belief was well articulated in March 2000, when Gary Gensler, then Under Secretary for Domestic Finance in President Clinton's Treasury Department and currently President Obama's nominee to chair the Commodity Futures Trading Commission (CFTC), testified before the House Financial Services Committee regarding systemic risk in our capital markets. Over the course of his remarks, Gensler explained that instead of advocating for new or increased regulations, the approach supported by Treasury emphasized the formative role of the private sector in protecting market participants:

> The public sector has three roles.... Promoting market discipline means crafting government policy so that creditors do not rely on governmental intervention to

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[115] Tim Critchfield with Tyler Davis, Lee Davison, Heather Gratton, George Hanc, and Katherine Samolyk, *Community Banks: Their Recent Past, Current Performance, and Future Prospects* (2004) (online at www.fdic.gov/bank/analytical/future/fob_03.pdf) (hereinafter "FDIC Future of Banking Study").

[116] John Kennedy, *Gov. Crist, State Regulators Reject State Farm's 7 Percent Rate Reduction*, Chicago Tribune (July 31, 2007) (online at www.chicagotribune.com/business/sfl-0731statefarm,0,3467689.story).

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safeguard them against loss.

Transparency is the necessary corollary to market discipline. The government cannot impose market discipline, but it can enhance its effectiveness by promoting transparency. Transparency lessens uncertainty and thereby promotes market stability.

Promoting competition in financial markets lessens systemic risk. The task of public policy must be to ensure the stability and integrity of the market system. In any sector of the financial market, the dominance of one or two firms can lessen competition and the efficiency of the market pricing mechanism. In addition, the entry of a subsidized financial institution into a market may motivate other firms to take on greater risks and weaken their operating results.[117]

Under Secretary Gensler had the right idea then, and his words should help provide the framework for the structural changes to our regulatory regime that we are now considering.

Observations on Current State of Financial Regulation

The United States has the most robust, accessible, and sound financial structure of any country in the world. That structure has provided unparalleled opportunities for millions, from seasoned market participants to casual investors to hardworking teachers and nurses hoping to live out the American dream. The success of our structure has been based on market discipline coupled with an appropriate level of regulation that fosters competition, transparency, and accountability.

Yet recently, this approach has been attacked by a small but vocal chorus claiming that two decades of financial deregulation has initiated the crisis that our financial system is now facing. These advocates of expanded government power contend that for years, government has been hard at work repealing all aspects of regulation in our financial sector. However, while such rhetoric might elicit some populist appeal, such claims do not bear scrutiny because the facts simply do not exist to support them.

One frequent argument heard from many critics is that the Gramm-Leach-Bliley Act (P.L. 106-102), which repealed the Depression-era Glass-Steagall Act's separation of investment and commercial banking, was somehow responsible for the current credit crisis. To the contrary, a wide variety of experts across the political spectrum have dismissed that claim as "a handy scapegoat"[118] at best. When asked in October 2008 if Gramm-Leach-Bliley was a mistake, Alice M. Rivlin, the former director of both the Congressional Budget Office and the Office of Management and Budget, testified: "I don't think so, I don't think we can go back to a world in which we separate different kinds of financial services and say these lines cannot be crossed. That wasn't working very well.... We can't go back to those days, we have got to figure out how to go forward."[119] Even former President Bill Clinton remarked in a 2008 interview that "I don't see that signing that bill had

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[117] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Gary Gensler, *Securities and Government Sponsored Enterprises*, 106th Cong. (Mar. 22, 2000) (online at financialservices.house.gov/banking/32200gen.htm).

[118] David Leonhardt, *Washington's Invisible Hand*, New York Times (Sept. 26, 2008).

[119] House Financial Services Committee, Oral Remarks of Alice Rivlin, *The Future of Financial Services Regulation*, 110th Cong. (Oct. 21, 2008) (online at financialservices.house.gov/hearing110/hr102108.shtml).

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anything to do with the current crisis."[120] If anything, Gramm-Leach-Bliley has played a significant role in attenuating the severity of this crisis by allowing commercial banks to merge with floundering investment banks—like JPMorgan Chase and Bear Stearns, Bank of America and Merrill Lynch, and Goldman Sachs and Morgan Stanley—actions that would have been explicitly prohibited had the Glass-Steagall Act still been in effect.

Although the advocates for expanded government power would have you believe otherwise, a careful examination of the historical record points toward the conclusion that regulation of the financial services sector has at least held constant if not substantially *increased* in recent years. One need only think about the sprawling regulatory mandate that the Sarbanes-Oxley Act (P.L. 107-204) imposed upon our financial system. Intended to toughen financial reporting requirements in the wake of the Enron scandal, Sarbanes-Oxley has created many needed reforms but its burden has also resulted in many companies taking their business—and their money—overseas. The result has been a flow of capital away from the U.S., capital which could have helped to shore-up American banks. In addition to Sarbanes-Oxley, over the last twenty years the federal government has implemented a wide array of new regulations on banks, mortgage lenders, and other financial services companies. These new regulations include:

1. The Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. 102-242), which was designed to improve bank supervision, examinations, and capital requirements.
2. The Home Ownership and Equity Protection Act (HOEPA) of 1994 (P.L. 103-325), which mandates enhanced disclosures by lenders who make certain high-cost refinancing loans to borrowers.
3. The 1989 and 2002 expansions of the mandated data furnished by lenders under the Home Mortgage Disclosure Act (HMDA).
4. The 2001 Bank Secrecy Act amendments made by the USA PATRIOT Act (P.L. 107-56), which enhanced anti-terrorist and money laundering record-keeping requirements for banks.
5. The Fair and Accurate Credit Transactions Act of 2003 (P.L. 108-159), which created new information sharing, indentify theft protection, and consumer disclosure mandates.
6. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8), which required lenders to provide new disclosures regarding credit offers and interest rates.
7. Various other Truth in Lending Act (TILA)/Regulation Z regulations and other federal banking agency guidance regarding lending, offers of credit, and consumer protections.

In fact, instead of wholesale deregulation, the case can be made that government has made concerted efforts to strengthen the very regulations that helped set the stage for the current financial crisis. To take one obvious example, there has been a strengthening of the Community Reinvestment Act, which has encouraged banks to make mortgage loans to borrowers who previously would have been rejected as non-creditworthy. Also, the Department of Housing and Urban Development's (HUD) affordable housing mandates for the government-sponsored enterprises (GSEs) were steadily increased from the 1990s through 2008, adding new targets and rules that compelled Fannie and Freddie to take certain loan purchasing actions to stay in compliance. Additionally, U.S. bank regulators are moving to quickly implement new capital

[120] *Bill v. Barack on Banks*, Wall Street Journal (Oct. 1, 2008) (online at online.wsj.com/article/SB122282635048992995.html).

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requirements through the Basel II capital accord, which was less than two years old when plans for its adoption were announced on September 30, 2005. These untested rules will replace the Basel I rules that generally assigned lower capital charges for housing assets, which tended to increase the leveraging of housing-related assets, making our financial system less stable.[121]

Furthermore, proponents of the "regulation is the cure" argument must bear in mind that the most egregious financial failures have occurred not in the unregulated financial markets of hedge funds and over-the-counter derivatives, but in the highly regulated world of commercial and investment banking, where regulation has been the most burdensome. The former U.S. investment banks—which bought the so-called toxic assets that have been identified as one of the root causes of the financial crisis—were regulated by the Securities and Exchange Commission (SEC). Yet that supervision was insufficient to prevent the collapse of Bear Stearns or Lehman Brothers, two of this nation's largest investment banks, or the charter transformation of two other large investment banks, Goldman Sachs and Morgan Stanley, into bank holding companies. The credit rating agencies that blessed these products with AAA ratings were also regulated by the SEC, yet that supervision was not enough to prevent the inaccurate evaluations and gross errors in judgment of those agencies.

This nation's highly regulated commercial banks, subject to regulation by several agencies similarly snapped up large quantities of these assets, all while supposedly under the oversight and supervision of their regulators. Yet the results of this country's heavy regulation of commercial banks have also been abysmal. Wachovia, formerly the nation's fourth largest bank, was regulated by the Comptroller of the Currency (OCC). Countrywide Financial was a national bank under OCC supervision until mid-2007, and then it became a federal thrift regulated by the Office of Thrift Supervision (OTS). Washington Mutual, IndyMac and Downey Savings and Loan Association were all also federal thrifts regulated by the OTS. All five were well regulated. And the housing market collapse caused all five to fail.[122]

By contrast, many of the less stringently regulated actors in the financial system, such as hedge funds and other private pools of capital, and less stringently regulated products, such as derivatives and swaps traded over the counter, seem to have weathered the crisis better than their highly regulated counterparts. While investors in some of those products have lost money, and some of the companies engaged in those lines of business have closed their doors, these failures did not produce massive systemic risk concerns that required federal intervention placing taxpayer dollars at risk.

These observations lead to the clear point that heavy regulation, despite the outsized claims made for its effectiveness in avoiding crisis, will not solve our problems. As financial historian Bernard Shull stated in a 1993 paper on the matter:

> Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted

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[121] Risk-based Capital Standards: Advanced Capital Adequacy Framework – Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 559, 560, 563, 567) (online at www.setonresourcecenter.com/register/2007/Dec/07/69288A.pdf).

[122] Binyamin Appelbaum and Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer*, Washington Post (Nov. 23, 2008.) (online at www.washingtonpost.com/wp-dyn/content/article/2008/11/22/AR2008112202213_pf.html).

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> optimism. The Comptroller of the Currency announced in 1914 that, with the new Federal Reserve Act, "financial and commercial crises or panics ... Seem to be mathematically impossible." Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform ... The Secretary of the Treasury proclaimed "two watchwords guided us as we undertook to solve this problem: Never Again."[123]

More than fifteen years after Shull's paper, many stand ready to march down the same well-worn path, clinging to the belief that heavy-handed regulation holds the answer. Those claims should be rejected. There is a better and more effective path to choose.

A Brief History of the Subprime Crisis

To some observers, the turmoil in the U.S. financial markets, caused by severe dislocations in the country's housing markets, has heralded the end of the free-market system. But with all due respect to the critics of capitalism, the economic crisis in which the country now finds itself reflects not the failure of the free-market system, but more so the result of decades of misguided government policies that interfered with the functioning of that system. While recent events demonstrate a need for regulatory reform, modernization, and improvement, the larger lesson is that a number of well-meaning but clearly misguided government policies distorted America's housing markets, which in turn produced grave consequences for the financial system and the underlying economy.

In a rush to be seen as doing "something" in response, the advocates of expanded government power have brought forward a range of old proposals to regulate, reregulate, and overregulate any and every aspect of our economy. We believe a more practical approach would be to identify and correct the government policies that inflated the housing bubble underlying this crisis and then decide what change is necessary. Thus, the essential debate is not between deregulation and re-regulation, but instead between *wise* regulation and *counterproductive* regulation. Wise regulation helps make markets more competitive and transparent, empowers consumers with effective disclosure to make rational decisions, effectively polices markets for force and fraud, and reduces systemic risk. Counterproductive regulation hampers competitive markets, creates moral hazard, stifles innovation, and diminishes the role of personal responsibility in our economy. It is also procyclical , passes on greater costs than benefits to consumers, and needlessly restricts personal freedom.

Those who simply advocate for reregulation because they claim that the free markets have failed ignore the various ways that government itself helped set the stage for the current financial crisis. The housing sector—where the difficulties confronting our markets started—is not a deregulated, free-market in any sense of the word. This country's housing market is overloaded with substantial government components, including the regulatory roles of large government agencies; implicit and explicit government guarantees supporting the underwriting, issuance, and securitization of mortgages; and a cluster of mandates aimed at achieving universal home ownership. Indeed, the crisis this country finds itself facing does not stem from deregulation (since little has taken place over the last couple of decades) or even the mistakes of participants in the free market (although

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[123] Bernard Shull, *The Limits of Prudential Supervision: Economic Problems, Institutional Failure and Competence* (1993) (online at www.levy.org/download.aspx?file=wp88.pdf&pubid=378).

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many harmful mistakes were committed), but instead from the myriad ways in which government initiatives interfered with the functioning of private markets.

Our observations have led us to conclude that there are at least five key factors that led to the current crisis:

1. A highly accommodative monetary policy that lowered interest rates dramatically, kept them low, and inflated the housing bubble.
2. Broad federal policies designed to expand home ownership in an "off-budget" fashion, which encouraged lending to those who could not afford home ownership.
3. The moral hazard inherent in Fannie Mae and Freddie Mac, the two failed GSEs, which exploited their congressionally granted duopoly status to benefit from privatized profits earned against socialized risks taken.
4. An anticompetitive government sanctioned credit rating oligopoly that misled investors and failed in its responsibility to provide accurate, transparent assessments of risk.
5. Failures throughout the mortgage securitization process that resulted in the abandonment of sound underwriting practices.

Monetary Policy. The Federal Reserve set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long earlier this decade. In response to the bursting of the high-tech bubble in 2000, the Federal Reserve began lowering interest rates in early 2001 to cushion the economic fallout. These highly accommodative policies were maintained in response to the 2001 recession and the economic shock of the 9-11 terrorist attacks. The target for the federal funds rate—the benchmark interbank lending rate in the U.S.—was lowered to just 1 percent by mid-2003, and maintained at that level until mid-2004.[124] The real funds rate—which is the difference between the funds rate set by the Federal Reserve and expected inflation—demonstrates just how aggressively the Federal Reserve was in conducting monetary policy during this period. The real funds rate dropped from 4 percent in late 2000 to -1.5 percent by early 2003.[125]

The Federal Reserve's decision to cushion the economic blow from the dramatic collapse in equity prices unleashed a wave of cheap credit on a housing market that was already experiencing a boom cycle. By mid-2003, the interest rate on a conventional thirty-year mortgage dipped to an all-time low of just 5.25 percent, fueling demand in the housing market thanks to mortgage credit that had become cheap and plentiful in light of the Federal Reserve's rate cuts.[126] As a result of demand and cheap credit, new home construction rose to a twenty-five-year high in late 2003, and remained at historic levels for two years.[127]

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[124] Federal Reserve Board, *Open Market Operations* (online at www.federalreserve.gov/fomc/fundsrate.htm) (accessed Jan. 26, 2009).

[125] Mark Zandi, *Financial Shock: A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis* (2009).

[126] Federal Reserve Bank of St. Louis, *Economic Research* (online at research.stlouisfed.org/fred2/series/MORTG/).

[127] *Remarks of John B. Taylor at the Symposium of Housing, Housing Finance, and Monetary Policy sponsored by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming* (Sept. 2007) (online at www.kc.frb.org/PUBLICAT/SYMPOS/2007/PDF/Taylor_0415.pdf).

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It has been widely reported that over the last fifty years, there has not been a single year in which the national average home value had fallen despite some regional declines and various economic troubles and recessions. The allure of this statistic was so appealing that even former Federal Reserve Chairman Alan Greenspan and current Chairman Ben Bernanke at various points attested to it in defense of our housing markets. In fact, a 2004 report by top economists from Fannie Mae, Freddie Mac, the National Association of Realtors, the National Association of Home Builders, and the Independent Community Bankers of America entitled *America's Home Forecast: The Next Decade for Housing and Mortgage Finance* even concluded that "there is little possibility of a widespread national decline since there is no national housing market."[128] This widely held belief augmented Federal Reserve monetary policy and further inflated the housing bubble.

Even with the brisk pace of home construction, demand still outstripped supply, pushing home prices even higher. Between 1995 and 2002, in the midst of the housing boom, home prices appreciated between 2 percent and 5 percent a year. By 2004 and 2005, at the height of the bubble, home prices were appreciating at nearly 15 percent per year. Between 1997 and 2006, real home prices for the U.S. as a whole increased 85 percent. Another measure of the unsustainable inflation that took place in housing prices is the relationship between house prices and rents. Over the past twenty-five years, the price-to-rent ratio was roughly 16.5. In 2003, at the start of the bubble, the price-to-rent ratio was 18.5. It then quickly grew to an all-time peak of 25 by the end of 2005.[129]

The bubble grew as cheap credit and sharply increasing home prices fueled the frenzy of first-time homeowners eager to buy into a market before prices got out of reach. It also encouraged current homeowners to purchase bigger homes or to buy additional properties for investment purposes. Federal Reserve economists have estimated that the share of investment real estate purchases jumped to roughly 17 percent in 2005 and 2006 at the height of the housing boom, up from just more than 6 percent a decade earlier.[130]

These double digit increases in housing prices not only stimulated demand among home buyers who wanted to get into the housing market before they were priced out or were eager to invest on rising home prices, they also created an environment in which lenders, securitizers, and investors believed that it was impossible to make a bad loan. The consequences should have been foreseeable. Borrowers bought bigger, more expensive homes, betting that perpetually rising housing prices would allow them to refinance their mortgages at a later date while benefiting from ongoing appreciation in housing values. Lenders assumed that even if buyers defaulted, rising house prices would allow them to sell the home for more than the amount owed by the borrower.

Economists have consistently identified the Federal Reserve's accommodative monetary policy as one cause of the current financial crisis. For example, John B. Taylor, a professor of economics at

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[128] David Leonhardt and Vikas Bajaj, *Drop Foreseen in Median Price of U.S. Homes*, New York Times (Aug. 26, 2007) (online at www.nytimes.com/2007/08/26/business/26housing.html?ei=5090&en=9bd44f2f8b0ef4f4&ex=1345780800&partner=rssuserland&emc=rss&pagewanted=all).

[129] Zandi, *supra* note 125; Robert J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do About It* (2008).

[130] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *The 2006 HMDA Data*, Federal Reserve Bulletin (Dec. 2007).

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Stanford and the creator of the "Taylor rule" guideline for monetary policy, has said the Federal Reserve made a mistake by keeping interest rates so low. According to Taylor's formula, the Federal Reserve should have raised interest rates much sooner than it did given the economic conditions at the time. Taylor himself has said that "a higher funds path would have avoided much of the housing boom.... The reversal of the boom and thereby the resulting market turmoil would not have been as sharp."[131] Given the key role that the Federal Reserve's monetary policy has played in contributing to the credit crisis we now face, it must be acknowledged that those decisions had a major impact on market conditions and helped to influence how investors chose to allocate their capital in our economy.

Federal Policy to Expand Home Ownership.. For well over twenty years, federal policy has promoted lending and borrowing to expand homeownership, through incentives such as the home mortgage interest tax exclusion, the Federal Housing Administration (FHA), and discretionary spending programs such as HUD's HOME block grant program. But perhaps the most damaging initiative undertaken by the federal government was the effort to pressure private financial institutions to subsidize home ownership through the Community Reinvestment Act (CRA). Undertaken with the best of intentions—expanding home ownership among poor and underserved communities—the unintended consequences of the CRA clearly demonstrate that government's attempts to manipulate market behavior to achieve social goals often lead to harmful results.

Enacted in 1977, the CRA encouraged banks to extend credit to "underserved" populations by requiring that banks insured by the federal government "help meet the credit needs of its entire community." To ensure that banks are meeting this mandate, each federally insured bank is periodically examined by its federal regulator. As a result of its enactment, bank lending to low- and moderate-income families has increased by 80 percent.[132]

In 1997, Wall Street firms, the GSEs, and the CRA converged in a landmark event: the first securitization of CRA loans, a $384-million offering guaranteed by Freddie Mac.[133] Over the next 10 months, Bear Stearns issued $1.9 billion of CRA mortgages, backed by Fannie or Freddie, and between 2000 and 2002 this business accelerated in dramatic fashion as Fannie Mae issued $20 billion in securities backed by CRA mortgages.[134] By encouraging lenders and underwriters to relax their traditional underwriting practices, the CRA, investment firms and the GSEs saddled American taxpayers with the consequences of mortgages that borrowers cannot repay.

Equally problematic are reports that some of these CRA-inspired loans are mortgages that borrowers can repay, but choose not to, given that the property that secures these loans is now worth less than the amount outstanding. Whether borrowers cannot or will not repay, the irony is that these lower-income home buyers—those who were supposed to benefit from the government's actions—are now defaulting at a rate three times that of other borrowers. With these defaults, the damage to

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[131] Taylor, *supra* note 127.

[132] U.S. Department of the Treasury, *The Community Reinvestment Act after Financial Modernization: A Baseline Report* (Apr. 2000).

[133] First Union Capital Markets Corp., *Bear, Stearns & Co. Price Securities Offering Backed By Affordable Mortgages Unique Transaction to Benefit Underserved Housing Market* (Oct. 20, 1997).

[134] *Fannie Mae Increase CRA Options*, ABA Banking Journal (Nov. 1, 2000).

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homeowners, neighborhoods, state and local governments as the tax base shrinks, and now to all American taxpayers, is enormous.

In the course of this crisis, there has been some heated discussion over the role CRA loans have played in contributing to our current woes. Proponents of CRA-like mandates have maintained that only a small portion of subprime mortgage originations are related to the CRA, and those CRA loans that have been written are performing in a manner similar to other types of subprime loans. Such claims, however, miss the fundamental point that critics of the CRA have made: though they may be small in volume, CRA loan mandates remain large in precedent because they inherently required lending institutions to abandon their traditional underwriting standards in favor of more subjective models to meet their government mandated CRA obligations.

For example, in April of 1993, the Boston Federal Reserve Bank, under the leadership of future Freddie Mac Chairman Dick Syron, published an influential best practices guide called *Closing the Gap: A Guide To Equal Opportunity Lending*. The guide made several recommendations to lending institutions on various ways they could increase their low-income lending practices. Some of these recommendations, which encouraged institutions to abandon the traditional lending and underwriting policies used to ensure the quality of loans made, included:

1. "Special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower-income, and nontraditional consumers."
2. "Policies regarding applicants with no credit history or problem credit history should be reviewed. Lack of credit history should not be seen as a negative factor.... In reviewing past credit problems, lenders should be willing to consider extenuating circumstances."
3. Institutions can "work with the public sector to develop products that assist lower-income borrowers by using public money to reduce interest rates, provide down payment assistance, or otherwise reduce the cost of the mortgage."
4. "A prompt and impartial second review of all rejected applications can help ensure fairness in the lending decision and prevent the loss of business opportunities.... This process may lead to changes in the institution's underwriting policies.... In addition, loan production staff may find that their experience with minority applicants indicates that the institution's stated loan policy should be modified to incorporate some of the allowable compensating factors."[135]

Taken in isolation, the good intentions of these recommendations is plain; taken together, however, it is also clear that lenders were being urged to abandon proven safety and soundness underwriting standards in favor of new outcome-based underwriting standards. Again, the salient point is not to debate the notion of could or should more be done to make affordable loans available to underserved communities. The question is what damage is done to the overall stability of an institution when it alters its lending guidelines to comply with a government mandate to advance a social policy.

Similarly, banks were urged by other private sector parties to ignore traditional lending guidelines,

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[135] Boston Federal Reserve, *Closing the Gap: A Guide to Equal Opportunity Lending* (Apr. 1993) (online at www.bos.frb.org/commdev/commaff/closingt.pdf).

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this time in the pursuit of greater and faster profit. In May of 1998, Bear Stearns published an article with guidance on why and how lenders should package CRA loans into mortgage backed securities.[136] That document advised lenders that: "Traditionally rating agencies view LTV [loan-to-value ratios] as the single most important determinant of default. It is most important at the time of origination and less so after the third year." Bear Stearns also encouraged lower lending standards by arguing that when "explaining the credit quality of a portfolio to a rating agency or GSE, it is essential to go beyond credit scores," and that "the use of default models traditionally used for conforming loans have to be adjusted for CRA affordable loans." While such advice might have been important to maximizing profitability, Bear Stearns' guidance is yet one more example of how the conflict between a social policy mandate like the CRA and the fiscal requirements of basic safety and soundness operations led to a dangerous diminution in lenders' traditional underwriting standards.

The GSEs. Standing at the center of the American system of mortgage finance are the two now-failed government-chartered behemoths created to expand homeownership opportunities: the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Market participants have long understood that this government created duopoly was implicitly, though not explicitly, backed by the federal government. This "implied guarantee" flowed from several factors, including the very existence of a government charter that effectively sanctioned this duopoly, access to a Treasury line of credit, and exemption from payment of state and local taxes. Although Fannie and Freddie were nominally designed to be competitors, in practice this implied guarantee allowed the two largely to work in unison as a cartel to set and maintain prices in the market.

The dangers inherent in such an implied guarantee were twofold. First, their unique status allowed Fannie and Freddie to borrow funds in the marketplace at subsidized rates. Ostensibly, these funds would be used to purchase mortgages from lenders, fulfilling their mission to provide liquidity in the secondary mortgage markets. For over a decade, however, the GSEs continued to build enormous investment portfolios, earning profits by arbitraging the difference between their low, subsidized borrowing costs and the higher yields in their portfolio's ever riskier assets. Beginning in 1990, their investment portfolios grew tenfold, from $135 billion to $1.5 trillion,[137] allowing many of their shareholders and executives to become personally wealthy thanks to the GSEs' subsidized borrowing costs while the American taxpayer assumed most of the risk.

Second, their implied guarantee created a false sense of security and standards for the products they purchased and securitized. This perception played a major role in the proliferation of GSE-backed subprime and Alt-A securities, providing a *de facto* government seal of approval for even the riskiest loans as market participants believed these securities were appropriately priced and represented minimal risk. Their predominance in the mortgage market meant that Fannie and Freddie's business practices—credit rating, underwriting, risk modeling—were seen as the "gold standard" in the industry, despite flaws that later became apparent.

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[136] Dale Westhoff, *Packaging CRA Loans into Securities*, Mortgage Banking (May 1, 1998) (online at www.allbusiness.com/personal-finance/real-estate-mortgage-loans/677967-1.html).

[137] U.S. Department of the Treasury, *Remarks of Assistant Secretary for Financial Institutions Emil W. Henry Jr., before the Housing Policy Council of the Financial Services Roundtable* (June 26, 2006) (online at www.ustreas.gov/press/releases/js4338.htm).

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For its part, Congress substantially magnified these potential risks by charging the GSEs with a mission to promote homeownership and thus inflating the supply of credit available to fund residential mortgages. The GSEs' congressional mandate and their access to cheap funding allowed the government to pressure Fannie and Freddie to expand homeownership to historically credit-risky individuals without the burden of an explicit on-budget line item at taxpayer expense, a budget goal long sought by housing advocates. For instance, in 1996, the HUD required that 42 percent of Fannie's and Freddie's mortgage financing should go to borrowers with income levels below the median for a given area.[138] HUD revised those goals again in 2004, increasing them to 56 percent of their overall mortgage purchases by 2008.[139] In addition, HUD required that 12 percent of all mortgage *purchases* by Fannie and Freddie be "special affordable" loans made to borrowers with incomes less than 60 percent of an area's median income, and ultimately increased that target to 28 percent for 2008.[140]

These "affordable housing" goals and other federal policies succeeded at increasing the homeownership rate from 64 percent in 1994 to an all-time high of 69 percent in 2005.[141] However, they did so at a great cost. To meet these increasingly large government mandates, Fannie and Freddie began to buy riskier loans and encouraged those who might not be ready to buy homes to take out mortgages. This GSE-manufactured demand boosted home prices to an artificially high level and fostered enthusiasm for the wave of exotic mortgage products that began to flood the market.

For example, in 1999, under pressure from the Clinton Administration to expand home loans among low- and moderate-income groups, Fannie Mae introduced a pilot program in fifteen major markets encouraging banks to extend mortgage credit to persons who lacked the proper credit histories to qualify for conventional loans. The risks of such a program should have been apparent to all. *The New York Times*, in a prescient comment on the program at the time, remarked: "In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting an economic rescue."[142]

During this period, the government also began to push Fannie and Freddie into the subprime market. In 1995, HUD authorized Fannie and Freddie to purchase subprime securities that included loans to low-income borrowers and allowed the GSEs to receive credit for those loans toward their mandatory affordable housing goals. Subprime lending, it was thought, would benefit many borrowers who did not qualify for conventional loans. Fannie and Freddie readily complied, and as a result, subprime and near-prime loans jumped from 9 percent of securitized mortgages in 2001 to 40 percent in 2006.[143]

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[138] Russell Roberts, *How Government Stoked the Mania*, Wall Street Journal (Oct. 3, 2008).

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, New York Times (Sept. 30, 1999).

[143] Roberts, *supra* note 138.

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Fannie's and Freddie's heavy involvement in subprime and Alt-A mortgages increased following their accounting scandals in 2003 and 2004 in an attempt to curry favor with Congress and avoid stricter regulation. Data from these critical years before the housing crisis hit show Fannie and Freddie had a large direct and indirect role in the market for risky mortgage loans. In 2004 alone, Fannie and Freddie purchased $175 billion in subprime mortgage securities, which accounted for 44 percent of the market that year. Then, from 2005 through 2007, the two GSEs purchased approximately $1 trillion in subprime and Alt-A loans, and Fannie's acquisitions of mortgages with less than 10-percent down payments almost tripled.[144]

Without question, the purchase and securitization of such loans by Fannie and Freddie was a clear signal and incentive to all loan originators to write more subprime and Alt-A loans regardless of their quality. As a result, the market share of conventional mortgages dropped from 78.8 percent in 2003 to 50.1 percent by 2007 with a corresponding increase in subprime and Alt-A loans from 10.1 percent to 32.7 percent over the same period.[145] The message, as *The New York Times* noted, was clear: "[T]he ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks."[146] Soon, Fannie and Freddie became the largest purchasers of the higher-rated (AAA) tranches of the subprime pools that were securitized by the market. This support was essential both to form these investment pools and market them around the world. Fannie and Freddie thus played a pivotal role in the growth and diffusion of the mortgage securities that are now crippling our financial system.

Fannie and Freddie also played a leading role in weakening the underwriting standards that had previously helped ensure that borrowers would repay their mortgages. For instance, in May 2008, Fannie and Freddie relaxed the down payment criteria on the mortgages they buy, accepting loans with down payments as low as 3 percent.[147] And in recent years both companies markedly stepped up their guarantees on Alt-A loans, which often did not require the verification of income, savings, or assets for potential borrowers. Between 2005 and the first half of 2008, Fannie guaranteed at least $230 billion worth of these risky loans, more than three times the amount it had guaranteed on all past years combined. However, these poorly underwritten loans are now increasingly turning sour amid the housing downturn, especially those concentrated in California, Florida, Nevada, and Arizona, where the housing bubble was particularly large and real estate speculation was rampant.[148]

To preserve their government-granted duopoly powers and maintain unfettered access to cheap funds, Fannie and Freddie spent enormous sums on lobbying and public relations. According to the

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[144] American Enterprise Institute, Peter Wallison and Charles Calomiris, *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac* (Sept. 30, 2008).

[145] Joint Center for Housing Studies, *The State of the Nation's Housing* (2008) (online at www.jchs.harvard.edu/publications/markets/son2008/index.htm).

[146] Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, New York Times (Oct. 5, 2008).

[147] *Fannie Mae Relaxes Loan Down Payment Requirements*, Reuters News Service (May 19, 2008).

[148] James R. Hagerty, *Fannie, Freddie Share Spotlight in Mortgage Mess*, Wall Street Journal (Oct. 16, 2008).

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Associated Press, they "tenaciously worked to nurture, and then protect, their financial empires by invoking the political sacred cow of homeownership and fielding an army of lobbyists, power brokers and political contributors."[149] Fannie and Freddie's lobbyists fought off legislation that might shrink their investment portfolios or erode their ties to the federal government, raising their borrowing costs. In fact, Franklin D. Raines, Fannie Mae's former chairman, once told an investor conference that "we manage our political risk with the same intensity that we manage our credit and interest rate risk."[150] Raines's statement was undoubtedly true: over the past ten years, Fannie and Freddie spent more than $174 million on lobbying.[151]

As long as times were good, the GSEs were able to point to their affordable housing goals to distract attention from the inherent risk their business model posed. But, for more than a decade, alarms have been sounded about the precarious position of the GSEs. For example, in Congress, as far back as 1998, GSE reform advocates like former Rep. Richard Baker were voicing their concerns over "the risks and potential liabilities that GSEs represent."[152] In 2000, Rep. Baker demonstrated he was far ahead of the curve when he observed that by "improving the existing regulatory structure of the housing GSEs in today's good economic climate, we can reduce future risk to the taxpayer and the economy."[153] That year, the House Financial Services Committee held no fewer than six hearings on the subject of GSE reform, with at least five more over the following two years.[154] Yet from 2000 to 2005, although at least eight major GSE reform bills were introduced in Congress, Fannie and Freddie exerted enough influence that only one, the Federal Housing Finance Reform Act of 2005, ever gained enough support to be passed by either body, but it ultimately did not become law.[155]

Others in government shared similar concerns. In 1997, the General Accountability Office cautioned in its testimony before the House Financial Services Committee that "the outstanding volume of federally assisted GSE credit is large and rapidly increasing."[156] As referenced above, then-Treasury Under Secretary Gensler testified in March 2000 that "the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that

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[149] Tom Raum and Jim Drinkard, *Fannie Mae, Freddie Mac Spent Millions on Lobbying,* Associated Press (July 17, 2008).

[150] Wallison and Calomiris, *supra* note 144.

[151] *Fannie Mae, Freddie Mac Spent Millions on Lobbying*, Associated Press (July 17, 2008).

[152] House Financial Services Committee, Statement of Rep. Richard Baker, *Joint Hearing on Government Sponsored Enterprises*, 105th Cong. (July 16, 1997) (online at financialservices.house.gov/banking/71697bak.htm).

[153] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Statement of Rep. Richard Baker, *Housing GSE Regulatory Reform Hearing*, 106th Cong. (March 22, 2000) (online at financialservices.house.gov/banking/32200bak.htm).

[154] House Financial Services Committee, *Archived Hearings* (online at http://financialservices.house.gov/archive_hearings.html).

[155] H.R. 1461, 109th Cong. (2005)

[156] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Jim Bothwell of the Government Accountability Office, *Joint Hearing on Government Sponsored Enterprises*, 105th Cong. (July 16, 1997) (online at financialservices.house.gov/banking/71697gao.htm).

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mortgage." Gensler went on to state that as the GSEs continue to grow, "issues of potential systemic risk and market competition become more relevant," and concluded that the current moment was "an ideal time to review the supervision and regulation of the GSEs."[157] In 2004, then-Federal Reserve Chairman Alan Greenspan warned in his testimony before the Senate Banking, Housing, and Urban Affairs Committee that "the current system depends on the risk managers at Fannie and Freddie to do everything just right.... But to fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later."[158]

Outside of Congress, more red flags were flown over the obvious weaknesses of the GSE model. At another House Financial Services Committee hearing on GSEs in 2000, low-income housing advocate John Taylor of the National Community Reinvestment Coalition warned that the lack of a strong regulatory agency for Fannie and Freddie "threatens the safety and soundness of the GSEs."[159] At the same hearing, community activist Bruce Marks of the Neighborhood Assistance Corporation of America expressed his fears that without enhanced regulatory control over Fannie and Freddie, the GSEs might participate "in potentially profitable but also potentially risky investments [*sic*] schemes [that] pose potential risks for the housing and banking industry and for the economy in general."[160]

Unfortunately, despite all the evidence of systemic risk and repeated efforts to consolidate, strengthen, and increase regulatory oversight of Fannie and Freddie, calls for reform mostly fell on deaf ears. One reason why reform efforts failed was that the GSEs and their ardent defenders in Congress have spent the better part of the last decade first ignoring, then rejecting, then attempting to contradict the mounting evidence that the whole system was in danger. In 2001, Fannie Mae itself attempted to dispel the need for any change, declaring before Congress that "we operate successfully under the most rigorous of safety and soundness regimes; we are subject to a high level of market discipline and provide the marketplace with world-class disclosures."[161] Freddie Mac, for its part, used the same hearing to proclaim that their "superior risk management capabilities, strong capital position and state-of-the-art information disclosure make Freddie Mac unquestionably a safe and sound financial institution."[162]

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[157] Gensler, *supra* note 117.

[158] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Alan Greenspan, *Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises*, 108th Cong. (Feb. 24, 2004) (online at www.access.gpo.gov/congress/senate/pdf/108hrg/21980.pdf).

[159] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of John Taylor, *Hearing on Improving Regulation of Housing GSEs*, 106th Cong. (June 15, 2000) (online at financialservices.house.gov/banking/61500tay.htm).

[160] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Bruce Marks, *Hearing on Improving Regulation of Housing GSEs*, 106th Cong. (June 21, 2000) (online at financialservices.house.gov/banking/62100mar.htm).

[161] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of J. Timothy Howard of Fannie Mae, *Hearing on Reforming Fannie Mae and Freddie Mac*, 107th Cong. (July 11, 2001) (online at financialservices.house.gov/media/pdf/071101th.pdf).

[162] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government

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After their credibility eroded from their accounting scandals, Fannie and Freddie increasingly relied on elected officials to fight attempts at reform. In 2003, Rep. Barney Frank famously remarked at a hearing on a pending GSE reform bill: "I believe there has been more alarm raised about potential [GSE] un-safety and unsoundness than, in fact, exists.... I do not want the same kind of focus on safety and soundness that we have in OCC and OTS. I want to roll the dice a little bit more in this situation towards subsidized housing."[163] In 2004, Senator Chris Dodd called Fannie and Freddie "one of the great success stories of all time,"[164] while in 2005 Senator Chuck Schumer confessed that perhaps "Fannie and Freddie need some changes, but I don't think they need dramatic restructuring in terms of their mission."[165] The scope of this head-in-the-sand mentality was perhaps most completely embodied by Rep. Maxine Waters who, in 2002, categorically rejected the need for any GSE reform bill, proclaiming at a House Financial Services Committee hearing on the matter "If it is not broken, why fix it?"[166]

Although it is fair to say that no one ought to be blamed for lacking the ability to predict the future, the fact remains that for more than a decade there were clear, discernable, and announced warnings that Fannie and Freddie were growing too big and that if left unchecked would eventually collapse beneath their own weight. Too many public policy makers failed to heed those warnings, or knowingly disregarded them, and as a result taxpayers have now been left to pick up the pieces by taking on hundreds of billions of dollars worth of risk. Ironically, when the housing bubble finally burst, the resulting wave of foreclosures stemming from loans the GSEs forced into the market will likely end up reducing homeownership rates across the country, a direct contradiction to the stated purpose of Fannie and Freddie that their supporters for so long sought to advance.

Credit Rating Agencies. In order to sell subprime securities to investors, those securities first had to be rated by the credit rating agencies. Like so many other players, the credit rating agencies were caught up in the pursuit of fees generated from the real estate boom. This overwhelming desire to maximize their profits from the housing bubble is perhaps best captured by an e-mail message from a Standard & Poor's official who wrote that "We rate every deal. It could be structured by cows and we would rate it."[167] To perform their work, these agencies made extensive use of sophisticated modeling in an attempt to predict risk and the likelihood of default on loans. However, much like everyone else, the credit rating agencies falsely assumed that housing prices would never go down nationwide, which meant that their elaborate mathematical models were defective from the start. When mortgage defaults accelerated and home prices began to plummet, securities based on those

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Sponsored Enterprises, Testimony of Mitchell Delk of Freddie Mac, *Hearing on Reforming Fannie Mae and Freddie Mac*, 107th Cong. (July 11, 2001) (online at financialservices.house.gov/media/pdf/071101md.pdf).

[163] House Financial Services Committee, Oral remarks of Rep. Barney Frank, *Hearing on H.R. 2575, The Secondary Mortgage Market Enterprises Regulatory Improvement Act*, 108th Cong. (Sept. 25, 2003) (online at financialservices.house.gov/media/pdf/108-54.pdf).

[164] *What They Said About Fan and Fred*, Wall Street Journal (Oct. 2, 2008).

[165] *Id.*

[166] House Financial Services Committee, Statement of Rep. Maxine Waters, *Hearing on Housing Government Sponsored Enterprises*, 107th Cong. (July 16, 2002) (online at financialservices.house.gov/media/pdf/071602wa.pdf).

[167] House Committee on Oversight and Government Reform, *Hearing on Credit Rating Agencies and the Financial Crisis*, 110th Cong. (Oct. 22, 2008) (online at oversight.house.gov/documents/20081023162631.pdf).

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loans that were once highly rated were downgraded to junk causing a wave of financial turmoil for scores of market participants at every level.

But the failure of the credit rating agencies would not have generated the disastrous consequences that it did had that failure not been compounded by further misguided government policies, which had effectively allowed the credit rating agencies to operate as a cartel. For decades, federal financial regulators have required that regulated entities heed the ratings of a select few rating agencies. For example, since the 1930s regulators have not allowed banks to invest in bonds that are below "investment grade," as determined by the select few rating agencies as recognized by the government. Although the goal of having safe bonds in the portfolios of banks may be a worthy one, bank regulators essentially delegated a major portion of their safety assessments to the opinions of these rating agencies.

This delegation of authority by bank regulators was further compounded in 1975, when the SEC also delegated its safety judgments regarding broker-dealers to the credit rating agencies. As an attempted safeguard against unqualified agencies from participating in the process, the SEC created a new Nationally Recognized Statistical Rating Organization (NRSRO) designation for qualified entities, and immediately grandfathered the three large rating agencies into this category. Following the SEC, other financial regulators soon adopted the NRSRO category for their delegations, assuming this government stamp of approval would ensure the continued quality of the ratings produced by those agencies.

Over the next 25 years, the SEC allowed only four more rating firms to achieve the NRSRO designation, but mergers among the NRSROs eligible to issue ratings recognized by the regulators shrunk the number of NRSROs back to three by year-end 2000. In 2006, Congress passed legislation (Pub. L. No. 109-291) to address part of this situation which required that the SEC cease being a barrier to entry for legitimate rating agencies, and gave it limited regulatory powers over the NRSROs. Although the SEC has designated six additional NRSROs since 2000,[168] competition and transparency in the ratings agency system remains inadequate. The SEC has never developed criteria for the designation and, once designated, NRSROs have for too long been allowed to operate without further scrutiny by the SEC for competence or accuracy.

By adopting this NRSRO system, the SEC thus established an insurmountable barrier to entry into the rating business, eliminating market competition among the rating agencies. No one could be surprised that once they were spared the market discipline, the quality of the work by protected rating agencies would diminish.

Market Behavior. Government policies that dominated and distorted the nation's housing market clearly set the stage for the housing crisis. But there were also significant mistakes made by private-sector participants at each step of the originate-to-distribute model of mortgage financing which compounded the government's failure. The benefits of this system—such a lower financing costs and the efficient distribution of risk—were significant. Over time, however, the belief that home prices would continue their relentless, upward path distorted began to distort decision making at every step along the path.

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[168] AEI Center for Regulatory and Market Studies, Lawrence J. White, *Lessons from the Debacle of '07-'08 for Financial Regulation and Its Overhaul* (Jan. 2009) (Working Paper No. 09-01).

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The belief that real estate prices would only go up led borrowers, originators, lenders, securitizers, and investors to conclude that these investments were risk free. As a result, the traditional underwriting standards, based on the borrower's character, capacity to repay, and the quality of collateral were abandoned. What many failed to realize was that those standards were designed not only to protect the participants in the system from the consequences of a bubble, but also to protect the underlying financial system itself.

Borrowers. Building on that belief that housing prices could never go down, borrowers were encouraged to borrow as much as possible and buy as much house as they possible could, or else invest in other properties that could always later be resold for a profit. The result was that borrowers often ended up with mortgage products that they failed to understand, that they could not afford, or that ended up exceeding the value of the property securing the mortgage. Those concerns were less important as property values continued to rise, since borrowers could always refinance or sell to benefit from the continued appreciation of the property. However, when property values began to fall, in many cases borrowers soon realized that the economically rational course of action for them was to mail in their keys to the mortgage servicer and simply walk away. Since mortgages are non-recourse loans, doing so meant that someone else was bearing the downside risk. While the vast majority of borrowers continue to honor their commitments and pay their mortgages, for many of those who put little or no money down their mortgages became a "heads I win, tails you lose" proposition.

Mortgage Originators. Because mortgage originators were compensated on the quantity rather than the quality of loans they originated, there was little incentive to care if the loans they originated would perform. The compensation of mortgage brokers was also tied to the interest rates and fees paid by customers, which created a financial incentive for some brokers to direct borrowers to loans that may not have otherwise been in their best interest. For example, some originators who advocated for certain subprime loans received commissions that were more than twice as high as the commissions they would have received for higher-quality loans. This incentives model put a much higher premium on quantity over quality, which only diminished the safety and soundness of the entire system as even more risks were externalized while profits were internalized.

Mortgage Fraud. Integral to understanding the root causes of our current credit crisis is an acknowledgement of the rampant mortgage fraud that took place in the mortgage industry during the boom years. Fueled by low interest rates and soaring home values, the mortgage industry soon attracted both unscrupulous originators as well as disingenuous borrowers, resulting in billions of dollars in losses. As early as 2004, FBI officials in charge of criminal investigations foresaw that mortgage fraud had the potential to mushroom into an epidemic. In 2008, the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) announced a 44 percent increase in Suspicious Activity Reports from financial institutions reporting mortgage fraud, with some 37,313 mortgage fraud reports filed in 2006, and 52,868 mortgage fraud reports filed in 2007. According to FinCEN, mortgage loan fraud was the third most prevalent type of suspicious activity reported, lagging behind only money laundering and check fraud. From 2000 to 2007, FinCEN found that the reporting of suspected mortgage loan fraud had increased an astounding 1400 percent from 3,515 cases in 2000 to 52,868 cases in 2007.[169]

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[169] Financial Crimes Enforcement Network, *FinCEN Assessment Reveals Suspected Mortgage Loan Fraud*

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Unfortunately, law enforcement officials failed to stop the epidemic that they had accurately diagnosed because they did not devote adequate resources to the problem. Even though the FBI and the Justice Department are charged with the responsibility of investigating and prosecuting illegal activities by originators, lenders, and borrowers, the focus of those agencies was trained on national security and other priorities. As a result, inadequate attention was paid to many of the white-collar crimes that contributed to the financial crisis. For example, by 2007, the number of agents pursuing mortgage fraud shrank to around 100.[170] By comparison, the FBI had about a thousand agents deployed on banking fraud during the S&L bust of the 1980s and 1990s. Although the FBI later increased the number of agents working on mortgage fraud to 200, others have pointed out that the agency might have averted much of the problem had it heeded its own warning about widespread mortgage fraud.[171]

Lenders. The belief that housing prices would rise forever, coupled with the ability to package loans for sale to investors, profoundly changed the way in which lenders underwrote loans. While underwriting had traditionally been based on the borrower's ability to repay a loan, as measured by criteria such as employment history, income, down payment, credit rating, and loan-to-value ratios, rising home prices pushed lenders to abandon these criteria. Little concern was paid to the risks of this change, given that in a worst-case scenario, servicers could always foreclose upon a property to satisfy the mortgage in full. As a result, lenders pioneered new mortgage products, such as no-doc and low-doc loans, low- and no-down-payment loans, and innovations that took rising home prices for granted. That is not to say that these exotic products are illegitimate; each may have its own appropriate use for borrowers in specific circumstances. But the broad application of these tailored products to *any* person in *any* circumstance invariably led to some borrowers receiving loans that were wholly inappropriate for their needs and capacity to repay. The ability to securitize these loans further degraded lending standards by allowing lenders to shift the risk of nonperforming mortgages onto the investors that purchased securities built around these products. In a world in which lenders could securitize even the most poorly underwritten of mortgages, what mattered most to lenders was that the loan did not default within an agreed-upon period—typically 90 or 180 days. Whatever happened after that time was someone else's problem.

Securitizers. Securitizers pooled mortgages of all types and quality together to create complex and often opaque structured products from these loans, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO). Securitizers knew that some portion of the mortgages they securitized would fail, but they believed that by structuring these mortgages into securities with different levels of risk, they could effectively eliminate any risk from those defaults with the guarantee of safer, performing loans. This belief grew from the assumption that others along the chain—the mortgage brokers and lenders—had adequately underwritten the loans so that any defaults would be manageable, and that housing prices would never go down. Those false assumptions belied the fact remains that in any finance model, you can never eliminate risk from a system of lending; at best, you can hope to control it by offsetting smaller sections of riskier loans with larger sections of safer loans. But that risk, while controlled, is always there, a lesson which the

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Continues to Rise (Nov. 3, 2007).

[170] Richard B. Schmitt, *FBI Saw Threat of Loan Crisis,* Los Angeles Times (Aug. 25, 2008).

[171] *Id.*

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entire financial system is currently experiencing firsthand.

Investors. Like so many others, private investors in pursuit of risk-free investments failed to appreciate that if housing prices could go up, they could also go down. Rather than performing their due diligence on these mortgage-backed securities, many investors put their faith in the rating agencies and other proxies, and did not fully appreciate the risks they faced. Some large institutions further compounded their mistakes by holding their mortgage investments off-balance-sheet, using a loophole set forth in the regulatory capital requirements that permitted them to hold low-risk investments in special investment vehicles or conduits. And other large institutions—such as the former investment banks—availed themselves of an exemption granted by the SEC that permitted them to ignore traditional debt-to-net capital ratios—traditionally 12:1—and lever up as much as 40:1.[172] It was in this way that the once highly sought but ultimately poorly underwritten mortgages came to be the "troubled assets" that have now caused the collapse of so many in our financial system. Using first the assumption, and by 2008 the proof, that the government would deem certain institutions that had gambled on these assets to be too big or too interconnected to fail, these institutions and their creditors succeeded in making the taxpayer the ultimate bag holder for the risks they took, demonstrating yet again that the standard governing the housing boom and bust was "heads I win, tails you lose."

Mark-to-Market Accounting. The boom and bust nature of the housing and financial markets in recent years was amplified by the application of financial accounting standards that required financial institutions to write down their MBS assets to "market value" even if no market existed. As a result, institutions that held mortgage-backed securities found themselves facing the withdrawal of financing, often forcing them to sell these assets at distressed or liquidation prices, even though the underlying cash flows of these portfolios might not have been seriously diminished. In a liquidity-starved market, more and more distressed sales took place, further pulling down asset prices. These declining prices in turn created more lender demands for additional collateral to secure their loans, which in turn resulted in more distressed sales and further declines in asset values as measured on a mark-to-market basis. The result was a procyclical engine which magnified every downward price change in a recursive spiral, all of which might have otherwise been avoided had the mark-to-market standard provided better guidance on how to value assets in non-functioning markets.

Summary. The financial crisis which has unfolded over the past two years has numerous causes, and decisions made in the private sector were, in many cases, unwise. But the failure of government policy and the market distortions it caused stand at the center of the crisis. Whether by the Federal Reserve's engineering an artificially low interest rate, Congress's well-intentioned but misguided efforts to expand home ownership among less creditworthy borrowers, or the GSEs' securitization and purchase of risky mortgage-backed securities, the federal government bears a significant share of the responsibility for the challenges that confront us today.

To address these challenges, what is needed most is not simply reregulation or expanded regulation, but a modernized regulatory system that is appropriate to the size, global reach, and technology used by today's most sophisticated financial service firms. At a time when our nation's economy desperately needs to attract new investment and restore the flow of credit to where it can be used

[172] Stephen Labaton, *Agency's '04 Rule Let Banks Pile on New Debt,* New York Times (Oct. 2, 2008).

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most productively, we must at all costs avoid regulatory changes under the label "reform" that have the unintended consequence of further destabilizing or constricting our economy. We should carefully consider the so-called lessons of the subprime crisis to be sure that whatever changes we adopt actually address the specific underlying causes of the crisis. These reforms should require the participants in the financial system to bear the full costs of their decisions, just as they enjoy the benefits. They should also enhance market forces, add increased transparency, and strip away counterproductive government mandates.

Perhaps above all, we should avoid creating a system in which market participants rely upon an implicit or explicit government guarantee to bear the risk for economic transactions gone wrong. If the events of the past two years have demonstrated anything, it is that whenever government attempts to subsidize risk—from efforts to stabilize home prices to the latest government-engineered rescues of financial institutions deemed too big to fail—those efforts are usually costly, typically ineffectual, and often counterproductive. We should all know by now that whenever government subsidizes risk, either by immunizing parties from the consequences of their behavior or allowing them to shift risk to others at no cost, we produce a clear moral hazard that furthers risky behavior, usually with disastrous consequences.

Any regulatory reform program must recognize the ways in which government is part of the problem, and should guard against an overreaction that is certain to have unintended consequences. Perhaps Harvard economist Edward L. Glaeser put it best: "We do need new and better regulations, but the current public mood seems to be guided more by a taste for vengeance than by a rational desire to weigh costs and benefits. Before imposing new rules, we need to think clearly about what those rules are meant to achieve and impose only those regulations that will lead our financial markets to function better."[173]

Recommendations for Federal Regulatory Reform

Developing an agenda for reform is an inherently controversial enterprise. As with any suggested change, some will stand to benefit while others might be forced to adjust to the new realities of a different regulatory scheme. The recommendations contained here are not immune from this charge, and there will invariably be disagreement over the advantages and disadvantages of some of these proposals. However, we believe that the following recommendations remain true to our objectives of helping to make markets more competitive and transparent, empowering consumers with effective disclosure to make rational decisions, effectively policing markets for force and fraud, and reducing systemic risk.

In considering the appropriateness of each item, the devil will always be in the details regarding how any of these recommendations might be enacted. Even the best idea, if poorly implemented, would lose many of the potential benefits it might otherwise yield. Thus, these recommendations are best understood as conceptual proposals rather than specific instructions for how to improve our regulatory system.

Given the limited time and resources available to the Panel to conduct this review, in many cases

[173] Edward L. Glaeser, *Better, Not Just More, Regulation*, Economix (Oct. 28, 2008) (available at economix.blogs.nytimes.com).

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there are still unanswered questions about certain aspects of these reforms and in some cases even a few qualified reservations between the authors. Nevertheless, we believe that each proposal contains clear benefits for our economy, and has been structured to avoid the potential for unintended consequences. They deserve open consideration and debate in the public arena, and the opportunity to stand or fall on their own merits—a fitting tribute to the competitive free-market system that we are dedicated to strengthening and preserving.

1. Reform the Mortgage Finance System. The current financial crisis originated in the mortgage finance system, and much of the resulting turmoil can be traced to government interventions in the housing sector which helped fuel a classic asset bubble. Reform must begin with Fannie Mae and Freddie Mac, the GSEs whose influence drove the deterioration of underwriting standards, growth in subprime mortgage backed securities, and whose subsidized structure will result in hundreds of billions of dollars in taxpayer losses. The mortgage origination market itself should also be improved by establishing clearer standards, transparency, and enforcement.

1.1 Re-charter the housing GSEs as mortgage guarantors, removing them from the investment business.

At the center of the need for reform are Fannie Mae and Freddie Mac. As Charles Calomiris and Peter Wallison of AEI recently wrote: "Many monumental errors and misjudgments contributed to the acute financial turmoil in which we now find ourselves. Nevertheless, the vast accumulation of toxic mortgage debt that poisoned the global financial system was driven by the aggressive buying of subprime and Alt-A mortgages, and mortgage-backed securities, by Fannie Mae and Freddie Mac. The poor choices of these two GSEs—and their sponsors in Washington—are largely to blame for our current mess."[174]

The GSEs fueled the housing bubble through their ever expanding appetite for increasingly risky investments that they held in their massive portfolios. They financed these investments by borrowing at low, subsidized rates, and over time the firms became ever more dependent on their high yields to meet their earning targets. At one time, Fannie and Freddie accounted for more default risk than all other U.S. corporations combined—default risk implicitly backed by the federal government.[175] These risks to the taxpayer and the financial system were obvious, and should have been dealt with long ago.

Now that the GSEs have been taken into conservatorship, Congress has the opportunity to ensure that the damage they inflicted will never be repeated. This can be accomplished in one of two ways. One option is for Congress to phase out the GSEs' government charter and privatize them over a reasonable period of time following a model similar to that of the successful Sallie Mae privatization a decade ago. Legislation to that effect was introduced in the 110th Congress and will likely be re-introduced in the current Congress. These firms can and should compete effectively in the financial service marketplace on a level playing field without implicit or explicit taxpayer guarantees.

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[174] *Blame Fannie Mae and Congress for the Credit Mess*, Wall Street Journal (Sept. 23, 2008).

[175] Peter Wallison, *Regulating Fannie Mae and Freddie Mac* (May 13, 2005) (online at www.aei.org/publications/pubID.22514/pub_detail.asp).

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Alternatively, Congress could opt to recharter the GSEs as government entities whose only mandate is to guarantee and help securitize mortgages. Such a structure would remove them entirely from the investment business by prohibiting them from maintaining massive investment portfolios which have proven to be a tremendous source of systemic risk. In either alternative, Congress must avoid a return to the flawed public purpose/private ownership model that permitted the GSEs' shareholders to profit at taxpayer expense.

1.2 Simplify mortgage disclosure.
The events of the past year have made painfully clear that the vitality of our financial system depends on a well-functioning housing market in which borrowers are able and willing to abide by the terms of the mortgage contracts into which they have entered. Unfortunately, the needless complexity involved in obtaining a mortgage appears designed to keep borrowers from fully understanding these important agreements. One way to minimize this complexity is to place essential information for borrowers in a simple, one-page document that makes clear what borrowers need to know before they enter into what will be for many the biggest financial transaction they will ever undertake. This information will permit borrowers to make an appropriate decision regarding the costs and affordability of borrowing to buy a house. This one-page document would include such items as monthly payments, interest rate, fees, and possible changes in the amount of payments for adjustable rate mortgages including the maximum possible interest rate on the loan and the maximum monthly payment in dollars. The one-page document should also include the warning that home values can go down as well as up, and that the consumer is responsible for making the mortgage payments even when the price goes down.

1.3 Establish minimum equity requirements for government guaranteed mortgages.
Because federally guaranteed mortgages put the taxpayer on the hook for any potential associated losses, the taxpayer needs to be protected from opportunistic borrowers that might otherwise walk away from a mortgage if housing prices fall. One way to protect the taxpayer is require the borrower to provide a bigger downpayment. If the taxpayer is going to take on risk, it is only fair that the borrower share in that risk as well.

FHA loans currently require at least a 3.5 percent downpayment, which is clearly too low. The minimum downpayment for all government-insured or securitized mortgages should be raised immediately to at least 5 percent, and to as much as 10 percent or higher, over the next several years as market conditions improve. Lest the advocates of government-subsidized mortgages in which taxpayers bear the risk complain that 5 percent is too high, it bears pointing out that would still be *four times* as lenient as the 20 percent standard that was in place two decades ago.

1.4 Allow Federal Reserve mortgage lending rules to take effect and clarify the enforcement authority for mortgage origination standards.
In July 2008, the Federal Reserve approved a comprehensive final rule for home mortgage loans that was designed to improve lending and disclosure practices. The new Federal Reserve rule was designed to prohibit unfair, abusive or deceptive home mortgage lending practices, and it applies to all mortgage lenders, not just those supervised and examined by the Federal Reserve.

The final Federal Reserve rule adds four protections for "higher priced mortgage loans," which encompasses virtually all subprime loans. The final rule:

1. Prohibits lenders from making loans without regard to a borrower's ability to repay the loan.

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2. Requires creditors to verify borrowers' income and assets.
3. Bans prepayment penalties for loans in which the payment can change during the first four years of the loan (for other higher-priced loans, a prepayment penalty period cannot last for more than two years).
4. Requires creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

In addition, the Federal Reserve issued the following protections for all loans secured by a consumer's principal dwelling:

1. Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value.
2. Companies that service mortgage loans are prohibited from engaging in certain practices, such as pyramiding late fees.
3. Servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request.
4. Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days of a consumer applying for a mortgage loan.

Finally, the rule sets new advertising standards, which require additional information about rates, monthly payments, and other loan features. It also bans seven advertising practices it considers deceptive or misleading, including representing that a rate or payment is "fixed" when it can change.

These new rules represent a change in federal regulation that, regardless of whether or not one agrees with the degree to which consumers might benefit from all of these rules, will significantly alter the way in which the mortgage lending industry operates. Thus, before policymakers succumb to the desire to write additional rules and regulations, they should allow the Federal Reserve's new guidelines to take effect, monitor their impact upon mortgage origination, and clarify the authority for enforcing these new federal standards. Additionally, for these new rules to work effectively, they must be appropriately enforced. In particular, Congress should ensure that federal and state authorities have the appropriate powers to enforce these laws, both in terms of resources and actual manpower, for all mortgage originators.

1.5 Enhance securitization accountability standards.
The advent of securitization has been a tremendous boon to the mortgage industry, and countless millions of Americans have directly or indirectly benefited from the liquidity it has created. Nevertheless, the communicative nature of loans in the securitization process has helped diminish accountability among market participants, eroding the quality of many loans. Thus, to restore accountability, minimum standards should be set for all loans that are to be securitized so that securitizers retain some risk for nonperforming loans.

One proposal would be to link the compensation securitizers receive for packaging loans into mortgage-backed securities to the performance of those loans over a five year period, rather than the six-month put-back period that is the current standard. This change in compensation would thus give the securitizer an economic stake in the loan's long-term performance, aligning the

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securitizer's incentives with those of borrowers, investors, and the broader economy. Further, consideration should be given to applying additional limitations on the ability to securitize loans that carry with them an explicit government guarantee.

2. Modernize the Regulatory Structure for Financial Institutions. It has become a cliché to observe that if one were designing a regulatory system from scratch, one would not come up with the patchwork system of agencies with overlapping jurisdictions and conflicting mandates. The U.S. financial regulatory system is fractured among eleven federal primary regulatory agencies in addition to scores of state regulatory agencies. The system developed over a 200-year period, during which institutions largely lacked the ability to transact business nationwide, let alone globally. Insurance, securities, and bank products were sold by different institutions, and little cross-market competition existed.

During the past thirty years, changes in size and technology have opened financial markets to buyers and sellers around the globe, transaction times are now measured in fractions of a second, and consumers have been given access to a broad range of valuable products from a single provider. Innovations in products and technology, and the global nature of financial markets are here to stay. An unnecessarily fragmented and outdated regulatory system imposes costs in several ways: inefficiencies in operation, limitations on innovation, and competition restraints that are difficult to justify.

2.1 Consolidate federal financial services regulation.
The benefits of a more unified federal approach to financial services regulation have been a constant theme in proposals for regulatory reform, some of which were under consideration and announced before the onset of the current financial crisis. For example, the Group of 30, in its very first recommendation, called for "government-insured deposit taking institutions" to be subject to "prudential regulation and supervision by a single regulator."[176] The Committee on Capital Markets Regulation has similarly called for a consolidated U.S. Financial Services Authority (USFSA) that "would regulate all aspects of the financial system including market structure and activities and safety and soundness."[177] Treasury's Blueprint for a Modernized Financial Regulatory Structure recommends a Prudential Financial Regulatory Agency (PFRA) with oversight over "financial institutions with some type of explicit government guarantee associated with their business operations."[178]

The current regulatory structure for oversight of federally chartered depository institutions is highly fragmented, with supervision spread among at least five agencies including the OCC, OTS, FDIC, National Credit Union Administration (NCUA), and the Federal Reserve. Thus, Congress should streamline oversight of these federally chartered and insured institutions.

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[176] The Group of 30, *Financial Reform: A Framework for Financial Stability* (Jan. 15, 2009) (online at www.group30.org/pubs/recommendations.pdf).

[177] The Committee on Capital Markets Regulation, *Recommendations for Reorganizing the U.S. Financial Regulatory Structure* (Jan. 14, 2009) (online at www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf).

[178] U.S. Department of Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 31, 2008) (online at www.ustreas.gov/press/releases/reports/Blueprint.pdf) (hereinafter "Blueprint").

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2.2 Modernize the federal charter for insured depository institutions.
There are many kinds of insured depositories operating under unique charters including national banks, thrifts, state chartered members of the Federal Reserve system, state chartered nonmembers, credit card banks, federal and state credit unions, and state charted industrial loan corporations. While this vast array of institution type may have had a sound historical basis, changes in the national economy and regulatory landscape have made many of these differences functionally obsolete. Although regulatory competition can prove beneficial, the current state of duplicative banking regulation has several negative consequences as well, including unnecessary consumption of federal regulatory resources, consumer transparency, and differences in charters for largely similar institutions, which can lead to unfair competitive advantages for institutions governed by certain charters over others.

In particular, the OCC and the OTS play a very similar role for two classes of depository institutions which were once were quite different in nature, but now compete for the same customers, offering similar services. The thrift charter was originally instituted to foster the creation of financial services organizations to encourage home ownership by ensuring a wide availability of home mortgage loans. Due to a number of national policy changes that have been instituted over the last several decades to encourage homeownership and the decreasing share thrifts have of the residential mortgage market in relation to commercial banks, a unique thrift charter is no longer necessary to meet this goal. Moreover, the constraints of the thrift charter limit the diversification of thrifts' loan portfolios, which only exacerbates their ability to remain financially healthy in a weak real estate market.

Many individuals and organizations reviewing the current regulatory landscape have come to the conclusion that these agencies, and their corresponding federal thrift, and federal bank charters should be unified. In fact, back in 1994, former Federal Reserve Governor, John P. LaWare recommended combining the OCC with the OTS.[179] Similarly, in 1996, the GAO recommended that primary supervisory responsibilities of the OTS, OCC, and the FDIC be consolidated into a new, independent Federal Banking Commission.[180]

Congress should consider other steps to modernize and rationalize the federal charter system. Each class of charter should be reviewed for purpose, structure, cost and distinct characteristics. Unnecessary differences are potential sources of confusion, conflict, or taxpayer risk, and should be eliminated wherever possible.

2.3 Consolidate the SEC and CFTC.
Similar to the rationalization that is needed in banking regulation, consolidation of securities regulation in the U.S. through the merger of the SEC and the CFTC should also be undertaken. Most countries have vested the power to oversee all securities markets in one agency, and for good reason—more efficient, consistent regulation that protects consumers in a more uniform manner.

As the Treasury Blueprint states: "Product and market participant convergence, market linkages,

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[179] Walter W. Eubanks , U.S. Congressional Research Service, RL33036, , *Federal Financial Services Regulatory Consolidation: An Overview* (July 10, 2008), at 14.

[180] Government Accountability Office, *U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure* (Nov. 1996) (online at www.gao.gov/archive/1997/gg97023.pdf).

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and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. The realities of the current marketplace have significantly diminished, if not entirely eliminated, the original rationale for the regulatory bifurcation between futures and securities markets."[181]

It further notes that: "Jurisdictional disputes have ensued as the increasing complexity and hybridization of financial products have made 'definitional' determination of agency jurisdiction (i.e., whether a product is appropriately regulated as a security under the federal securities laws or as a futures contract under the CEA) increasingly problematic. This ambiguity has spawned a history of jurisdictional disputes, which critics claim have hindered innovation, limited investor choice, harmed investor protection, and encouraged product innovators and their consumers to seek out other, more integrated international markets, engage in regulatory arbitrage, or evade regulatory oversight altogether."[182]

In testimony before this panel, Joel Seligman, President of the University of Rochester and a leading authority on securities law, agreed, stating, a "pivotal criterion to addressing the right balance in designing a regulatory system is one that reduces as much as is feasible regulatory arbitrage. Whatever the historical reasons for the existence of a separate SEC and CFTC, the costs of having a system where in borderline cases those subject to regulation may choose their regulator is difficult to justify."[183]

The most significant obstacle to this proposal is a political one. Congressional oversight of the two agencies is split between two committees in both the House and Senate. Consolidation would most likely mean that one committee would lose out, leading to a classic turf war. Since the nature of futures trading has evolved significantly over the years, and is now dominated by non-agricultural products, the Senate Banking and House Financial Services Committees would be the appropriate venue for all congressional securities oversight.

2.4 Establish an optional federal charter for national insurance firms.
The U.S. federal financial service regulatory infrastructure contains no agency or organization responsible for oversight of national insurance firms. As far back as 1871, regulators saw the need for uniform national standards for insurance. That year, former New York Insurance Commissioner, George W. Miller, who founded the National Association of Insurance Commissioners (NAIC), made the following statement: "The Commissioners are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all States, not reciprocal but identical, not retaliatory, but uniform."[184] That need for uniform standards has grown quite considerably during the past 138 years.

Congress should institute a federal charter that may be utilized by insurance firms to underwrite,

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[181] Blueprint, *supra* note 178.

[182] *Id.*

[183] Seligman, *supra* note 18.

[184] House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Rep. Sue Kelly, *NARAB & Beyond: Achieving Nationwide Uniformity in Agent Licensing*, 107th Cong. (May 16, 2001) (online at financialservices.house.gov/media/pdf/051601ke.pdf).

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market, and sell products on a national basis. While individual state insurance regulators have effectively managed state guarantee pools, as well as safety and soundness within their jurisdiction, they simply are not equipped to effectively oversee a global firm such as AIG, which had 209 subsidiaries at the time the federal government acted to prevent its collapse in the fall of 2008. Of the 209 subsidiaries, only twelve fell under the jurisdiction of the New York insurance commissioner, which was effectively AIG's primary regulator.[185]

By allowing insurance firms to choose between a unified national charter or maintaining operations under existing state regulation, Congress can build upon the success of state guarantee pools and maintain state jurisdiction over premium taxes. A national charter would also allow regulators to take a comprehensive view of the safety and soundness of large insurance companies and to better understand the potential risks they may pose to the strength of the broader U.S. economy. Lastly, a federal insurance regulator would be able to implement effective consumer protection, provide a clear federal voice to coordinate global insurance regulation with foreign counterparts, and ensure appropriate access for U.S. insurance companies in overseas markets.

3. Strengthening Capital Requirements and Improving Risk Management. The experience of the past two years demonstrates that our financial system was far more susceptible to shocks from the housing sector than it should have been, as a result of capital requirements that were insufficient to sustain financial institutions in time of stress. Those weaknesses were in turn further exacerbated by certain standards and practices, such as a heavy reliance on credit rating agencies and the application of mark-to-market accounting standards. To ensure that our financial system can better withstand these kinds of shocks, capital requirements should be strengthened and risk management should be enhanced.

3.1 Strengthen capital requirements for financial institutions.
One of the key lessons that has emerged from this crisis is that our financial institutions did not have adequate capital reserves to weather the turmoil in the housing market due in large part to the fact that many of the assets they held were inextricably linked to this market. One way to address this problem would be to ensure that regulators can demand that financial institutions increase their capital during flush times. Those reserves could then serve as a cushion during bad times when capital is much harder to raise. The provisioning requirements would be based on the health of the economy as a whole, thus building upon systemic strength and buffering against systemic weakness.

These countercyclical requirements would be quite different from those governing the regulatory capital that financial institutions are required to hold today. The current capital rules for lending are out of date, subject to manipulation, and do not accurately reflect the risks associated with lending activities. That said, there are also significant flaws and risks associated with the new capital rules called for by the Basel II regime.

Much of the initial modeling now available suggests that average capital requirements for banks subject to Basel II methodologies would decrease. The determination to allow the largest and most complex banks to use internally developed, historical models for the purpose of determining capital risk charges merits further and closer scrutiny. Given the current financial crisis and the federal

[185] John Sununu, et al., *Insurance Companies Need a Federal Regulator*, Wall Street Journal (Sept. 23, 2008) (online at online.wsj.com/article/SB122212967854565511.html).

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guaranty on deposits that banks enjoy, weak capital requirements called for by Basel II could leave taxpayers on the hook yet again.

3.2 End conduits and off-balance-sheet accounting for bank assets.
Apart from its procyclicality, Basel II permitted banks and other financial institutions to keep assets such as mortgage-backed securities off their books in conduits or structured investment vehicles on the grounds that these assets were high-quality and low-risk. Even if such an assessment were accurate—and the past two years have demonstrated that it was not—off-balance-sheet arrangements such as this permit financial institutions to game the regulatory requirements in place. These off-balance-sheet arrangements were made even more dangerous by the perception that their liabilities were implicitly guaranteed by the institutions that sponsored them, which permitted even greater leverage to build before the credit crisis hit. Thus, all assets and liabilities of a financial institution should be held on the balance sheet. If nothing else, one of the lessons of this credit crisis is the necessary steps should be taken to eliminate the notion of an "implicit guarantee" of anything in our markets.

3.3 Adjust the application of mark-to-market accounting rules.
Fair value accounting should be revised and reformed. As things stand now, the accounting rules magnify economic stress and can have serious procyclical effects. When markets turn sour or panic, assets in a mark-to-market accounting system must be repeatedly written down, causing financial institutions to appear weaker than they might otherwise be. A superior accounting system would not require financial institutions to write down their assets at a time when prices have fallen precipitously during a rapid downturn as in the collapse of a bubble. Thus, alternative asset valuation procedures—such as discounted cash flow—should be used, and it should be made easier for financial institutions to declare assets as held-to-maturity during these periods. In normal markets, prices will fluctuate within a limited range, and will rise slowly if at all. But in times of crisis—such as the one we are facing—write-downs beget fire sales, which beget further write-downs.

In late September 2008, the SEC released guidelines that allowed companies greater flexibility in valuing assets in a nonfunctioning market. Such changes are encouraging. Moving forward, accounting rules have to provide transparency and the most accurate depiction of economic reality as possible. It is for the best that the development of accounting rules should not be conducted in the political arena. However, it is clear that the rules need to be improved, taking into account the lessons learned from recent events. Ultimately, greater transparency and accuracy in accounting standards are necessary to restore investor confidence.

3.4 Eliminate the credit rating agencies' cartel.
The failure of the credit rating agencies in the financial crisis could not be more apparent. Much like the GSEs, the credit rating agencies benefited from a unique status conferred upon them by the government. They operated as an effective oligopoly to earn above-market returns while being spared market discipline in instances where their ratings turned out to be inaccurate. The special status of the rating agencies should be ended so as to open the ratings field to competition from new entrants and to encourage investors and other users of ratings not to rely upon a ratings label as a substitute for due diligence.

3.5 Establishing a clearinghouse for credit default swaps

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Despite recent criticism heaped upon them, the thriving credit default swaps (CDS) market demonstrates the valuable role that innovation plays in improving the functioning of our financial markets. Through the use of CDS, investors and lenders can hedge their credit exposures more efficiently, thereby freeing up additional credit capacity, which has in turn enabled banks to expand credit facilities and reduce costs of funds for borrowers. CDS have enabled asset managers and other institutional investors to adjust their credit exposures quickly and at a lower cost than alternative investment instruments, and have enabled market participants to better assess and manage their credit. CDS have also enabled market participants to value illiquid assets for which market quotations might not be readily available.

Despite their many benefits and the crucial role that CDS have come to play in the financial system in managing risk, legitimate concerns have arisen regarding the transparency of the system and the management of counterparty risk. To address these concerns, the Federal Reserve, the CFTC, and the SEC have recently agreed on general principles to provide consistent oversight of one or more clearinghouses for CDS trades. The proposed guidelines will result in more public information on potential risks being provided to counterparties and investors, as well as the mitigation of any systemic losses caused by potential fallout from the CDS market.

These principles constitute a valuable first step in creating a CDS clearinghouse and will further improve a product that has thus far proven invaluable in managing risk when prudently used. A properly structured clearinghouse, capitalized by its members, spreads the risk of default and fosters market stability by acting as the sole counterparty to each buyer and seller. A clearinghouse will allow performance risk to be isolated to net exposure, rather than related to the much larger gross positions in the market.

A number of reforms have already reduced risk in the CDS market. The CDS market has already dramatically increased margin, mark-to-market and collateral requirements for hedge funds and other investment institutions on the other side of any trade. And at the behest of the New York Federal Reserve and other regulators, record keeping has improved; trade confirmations, for example, now must be tendered quickly. Buyers of CDS protection now also must formally approve any switch of their coverage from one insurer to another. Previously, the insured might not know who was its latest counterparty.

A clearinghouse, however, may not be appropriate for the most complex and unique over-the-counter derivatives. Moreover, because a clearinghouse arrangement spreads risk to other market participants, it could encourage excessive risk taking by some, especially if risks associated with more exotic products are not priced properly due to information asymmetry. Policy makers and regulators should continue to work with the private sector to facilitate a CDS clearinghouse that provides greater transparency and reduces systemic risk in the broader financial markets.

4. Address Systemic Risk.

4.1 Consolidate the Work of the President's Working Group and the Financial Stability Oversight Board to create a cross-agency Panel for identifying and monitoring systemic risk.

Systemic risk can materialize in a broad range of areas within our financial system: at both depository and nondepository institutions, within either consumer or commercial markets, as a result of poor fiscal or monetary policy, or initiated by domestic or global activity. Thus, it is impractical, and perhaps a dangerous concentration of power, to give one single regulator the power

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to set or modify any and all standards relating to such risk. Systemic risk oversight and management must be a collaborative effort, bringing together the leading authorities for addressing safety and soundness, managing economic policy, and ensuring consumer protection.

One alternative to a single systemic risk regulator would be to develop a panel of federal agencies to consider jointly these important questions. The Presidential Working Group (PWG) was established after the stock market crash of 1987 to make recommendations for enhancing market integrity and investor confidence. Similarly, the Financial Stability Oversight Board (FSOB) was established under the EESA in 2008 as a cross-agency group to oversee the Troubled Assets Relief Program (TARP) and evaluate the ways in which funds might be used to enhance market stability. Both groups include the Treasury, the Federal Reserve, and the SEC. The PWG adds the CFTC, while the FSOB includes the Housing Secretary and the Director of the Federal Housing Finance Agency (FHFA), which oversees the housing GSEs.

While the quarterly evaluation of TARP operations provided by the FSOB will continue through the life of the program, the broad mission and structure of these two organizations are, in many respects, redundant. Moreover, they represent the collaborative, cross-agency structure that would best provide insight in to the practices, policies, and trends that might contribute to systemic risk within the financial system.

By combining and refocusing the efforts of these two organizations, Congress can establish a body with the requisite tools to identify, monitor, and evaluate systemic risk. The panel can make specific legislative recommendations, as well as encourage immediate action consistent with the significant regulatory powers already vested in its members.

A Panel comprised of the Federal Reserve, the Treasury, the primary regulator of federally insured depository institutions, and the combined SEC/CFTC, would have authority to access detailed financial information from regulated financial institutions, require disclosure of information necessary to evaluate risk, and require that financial institutions to undertake corrective actions to address systemic weakness.

Disagreement with Panel Regulatory Recommendations

In far too many areas, the Panel Report offers recommendations or policy options that are rife with moral hazard and the potential for unintended consequences. Given that some of the principal causes of this financial crisis include the moral hazard embedded in the charter of Fannie Mae and Freddie Mac, market-distorting housing mandates like the CRA, and the unintended consequences of a credit rating agency certification process which restricted competition, we must be particularly mindful of these risks. In some cases, a highlighted action may appear benign, but the more detailed summary includes proposals or policy "options" that cannot be supported.

Other sections, such as those dealing with systemic risk and leverage, include highly proscriptive proposals that would be difficult, if not impossible to implement outside the walls of academia. Finally, the Panel Report all but ignores the critical role played by the Federal Reserve's highly accommodative monetary policy, and the host of troubles created by the government charter and implicit backing of the GSEs. Avoiding discussion of such important components of the crisis will inevitably lead one to set the wrong priorities for reform. While not exhaustive, the following represents a list of the more significant disagreements held with the Panel Recommendations for

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Improvement:

1. The Panel Report calls for a "body to identify and regulate institutions with systemic significance" and "[i]mpose heightened regulatory requirements for systemically significant institutions." The recommendations suggest that firms designated as such are to be subjected to unique capital and liquidity requirements, as well as special fees for insurance. Although it is important that regulators work to identify, monitor, and address systemic risk, such explicit actions are more likely to have unintended and severe negative consequences.

Publicly identifying "systemically significant institutions" will create significant moral hazard, the cost of which will far outweigh any potential regulatory benefits. Consider the two possible effects of being identified as such. First, in one case, the cost and burdens of additional capital and regulatory requirements (as recommended) place a firm at a competitive disadvantage relative to its peers. Thus, the competitive strength of a systemically significant firm is impaired, raising the probability of a business failure—an undesirable outcome.

In the alternative case, the market may view designation as a *de facto* guarantee of public support in during times of financial stress. The firm attains a beneficial market status, and enjoys advantages such as a lower cost of capital in the public markets. The costs of failure are thus socialized, while profits remain in private hands (much as was the case for the GSEs, Fannie Mae and Freddie Mac). Recent events make clear that this scenario is perhaps an even more undesirable outcome than the former.

Unfortunately, these are the only two practical outcomes of any designation—either markets will view it as a competitive burden or as a competitive advantage. It is unrealistic to argue that such a "significant" designation would be viewed as competitively neutral. Moreover, it is unreasonable to assume that government will manage the potential moral hazard more effectively than was done in the case of the GSEs.

2. The Panel Report recommends the formation of "a single federal regulator for consumer credit products." Such an action would isolate the activity of creating and enforcing consumer protection standards from oversight of safety and soundness in financial institutions.

The regulation of any federal financial firm requires the balancing of multiple policy choices and should be done by one institution. Experience has shown us with the GSE model that having two stated goals, one for safety and soundness and one for social policy, inherently will lead to conflict. Since the new consumer product regulator would be able to affect all financial institutions, eventually those rules will conflict with a bank's profitability, capital levels, and ultimately, solvency. Under this Panel proposal, an independent agency would have power to impose regulations that could well undermine the health of banks, but would not be responsible for the safety and soundness of those banks.

This balance is of particular significance within institutions that have been provided with explicit taxpayer funded guarantees, such as FDIC insurance. By placing both responsibilities with the same regulator, greater assurance is provided that taxpayer interests will not be placed in jeopardy by regulations that unnecessarily weaken capital or competitive position.

3. The Panel Report broadly calls for the adoption of new regulations to "to curtail leverage." While

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the recommendation implies that regulators across the spectrum of financial institutions set inappropriate standards for leverage, this simply is not the case.

Few, if any, observers of the current crisis have argued that capital standards set by the FDIC and other federal and state banking regulators overseeing depository institutions were set at dangerously low levels. To the extent that FDIC insured institutions have become troubled, it has been largely the results of deteriorating loan quality. Thousands of such institutions across the country remain strong and healthy. Raising their capital standards now in an effort to "curtail leverage" would be highly procyclical and would sharply limit the availability of credit for consumers and businesses.

Without question, there were some financial firms, notably non-depository institutions such as broker-dealers, that were allowed to raise their leverage ratios substantially in recent years. The SEC ruling issued in 2004, which allowed alternative net capital requirements for broker-dealers, contributed significantly to the failures of both Bear Sterns and Lehman Brothers. The regulatory decision to rely on internal models for risk weighting assets appears, in retrospect, to have been a major miscalculation.

Moreover, prudent regulators may wish to consider adopting capital policies that are more counter-cyclical as well, to encourage the building of stronger reserves during good times and ensure greater stability in periods of financial stress. Blanket mandates to "curtail leverage," however, will only restrict access to credit and limit successful lending models where they are needed most.

4. The Panel Report argues that: "Hedge funds and private equity funds are money managers and should be regulated according to the same principles that govern the regulation of money managers generally." The recommendation fails to recognize the important distinctions between investment firms and fails to explain why these distinctions should be ignored.

There exist clear and dramatic differences between managing capital allocation on behalf of a $5 billion dollar pension fund, and investing funds placed in a personal IRA or 401k. Under current law, private equity, venture capital, and hedge funds may not be marketed to retail investors. While they remain subject to all regulations regarding trading and exchange rules and regulations, they are not subject to the marketing and registration requirements designed to protect smaller, unsophisticated investors, because they do not serve that market.

Suggesting that more regulation should be imposed on these entities in light of the current crisis ignores the fact that even under the tremendous financial upheaval of the past year, no major hedge funds have declared bankruptcy, and taxpayers have been exposed to no losses resulting from failed hedge fund or private equity investment activity.

Finally, it may be worth noting that several high-profile hedge fund management firms were among the first to publicly and accurately assess the dangers inherent in the housing finance system, mortgage backed securities, and Fannie Mae and Freddie Mac.

5. The Panel Report call for Congress to "[e]liminate federal pre-emption of application of state consumer protection laws to national banks." Such a change would effectively defeat the purpose of a uniform federal charter for insured depository institutions.

As previously mentioned, the regulation of any federal financial firm requires the balancing of

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multiple policy choices and should be done by one institution. By giving state regulators the power to affect bank profitability, capital levels, and solvency standards, this proposal would greatly enhance risk and curtail innovation in our system. Under the Panel proposal, states would not be responsible for the safety and soundness of federally chartered banks, but would have authority to impose regulations that could well undermine the health of those banks.

Allowing states to impose their own consumer protection laws also undermines the fundamental purpose of a federal banking charter. Congress established federal financial charters to enable firms to offer products and services on a uniform national basis. Standardization of products and services lowers costs, and acts as an incentive for innovation by enabling new products to be brought to market sooner. Allowing every state to impose its own set of product or business standards on national banks would represent a step backwards, away from strong well-balanced federal regulation that allows national firms to compete effectively with global peers.

6. The Panel Report calls for new "tax incentives to encourage long–term-oriented pay packages," which would represent an unprecedented intervention in the operation of private employment markets.

The Federal Government should not structure the tax code to reward, penalize or manipulate compensation. Congress attempted to do this in the Omnibus Reconciliation Act of 1993, Pub..L. No. 103-66, which contained the so-called "Million-Dollar Pay Cap."[186] It not only failed to achieve the stated goals of its authors, it had unintended consequences: by raising taxes on cash compensation, more firms chose to compensate executives with large packages of stock options, resulting in numerous high-profile multimillion-dollar "pay days" when the options were exercised.

Compensation committees should establish executive pay policies that are fair, encourage sound long-term decisions, and are fully disclosed to shareholders and the public. Using the tax code to design an ideal pay structure will certainly have unintended negative consequences, as has been demonstrated by past action, nor will it be successful in deterring companies from paying their employees what they wish to attract and retain the best available talent.

7. The Panel Report calls upon Congress to "consider creating a Credit Rating Review Board" which would be given the sole power to approve ratings required by pension fund managers and others to purchase investment securities.

The credit rating system is badly in need of reform, but the main weakness in the current system has been the existence and operation of, effectively, a duopoly—a status created by the restraints of the government certification process. Giving a government operated Credit Review Board the power to sign off on all credit ratings brings the system to a single point of failure, and becomes a significant source of systemic risk. Improving the credit rating system will require more competition, an elimination of conflicts, and accountability. Regulators can facilitate this accountability by tracking the default levels of rated securities over time, and publicly disclosing the best and worst rating agency performance.

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[186] Omnibus Reconciliation Act of 1993, Pub. L. No. 103-66, at § 13211.

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Appendix: Other Reports on Financial Regulatory Reform

Other reports on financial regulatory reform that are comparable to this report in various respects are itemized in the following list and then briefly summarized in the table below. Reports in both list and table appear in reverse chronological order by the name of the issuing organization. In the list, each item is followed by a short-form reference in brackets.

Group of 30 (G-30). *Financial Reform: A Framework for Financial Stability*. January 15, 2009. http://www.group30.org/pubs/pub_1460.htm.
[G-30 January 2009]

Committee on Capital Markets Regulation. *Recommendations for Reorganizing the U.S. Financial Regulatory Structure*. January 14, 2009. http://www.capmktsreg.org/.
[CCMR January 2009]

Robert Kuttner, Prepared for Dēmos. *Financial Regulation After the Fall*. January, 2009. http://www.demos.org/pubs/reg_fall_1_8_09%20(2).pdf).
[Kuttner/Dēmos January 2009]

United States Government Accountability Office (GAO). *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System.* (GAO-09-216). January, 2009. http://www.gao.gov/new.items/d09216.pdf.
[GAO January 2009]

North American Securities Administrators Association. *Proceedings of the NASAA Financial Services Regulatory Reform Roundtable*. December 11, 2008. http://www.nasaa.org/content/Files/Proceedings_NASAA_Regulatory_Reform_Roundtable.pdf.
[NASAA December 2008]

President's Working Group On Financial Markets (PWG). *Progress Update on March Policy Statement on Financial Market Developments*. October, 2008. http://www.ustreas.gov/press/releases/reports/q4progress%20update.pdf
[PWG October 2008]

Group of 30 (G-30). *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*. October, 2008. http://www.group30.org/pubs/pub_1428.htm.
[G-30 October 2008]

Financial Stability Forum (FSF). *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience and the Follow-Up on Implementation*. April 7, 2008 and October 10, 2008. http://www.fsforum.org/about/overview.htm.
[FSF April 2008 and October 2008]

Basel Committee on Banking Supervision. *Principles for Sound Liquidity Risk Management and Supervision*. September, 2008. http://www.bis.org/publ/bcbs144.htm.
[Basel Liquidity Risk Management September 2008]

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Professor Lawrence A. Cunningham, for Council of Institutional Investors. *Some Investor Perspectives on Financial Regulation Proposals*. September, 2008. http://www.cii.org/UserFiles/file/Sept2008MarketRegulation.pdf. [Cunningham/CII September 2008]

The Counterparty Risk Management Policy Group (CRMPG) III. *Containing Systemic Risk: The Road to Reform*. August 6, 2008. http://www.crmpolicygroup.org/docs/CRMPG-III.pdf. [CRMPG III August 2008]

Institute of International Finance (IIF). *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007–2008*. July, 2008. http://www.ieco.clarin.com/2008/07/17/iff.pdf. [IIF July 2008]

Securities Industry and Financial Markets Association (SIFMA). *Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force*. July 2008. http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf. [SIFMA July 2008]

United States Securities and Exchange Commission Staff. *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies*. July, 2008. http://www.sec.gov/news/studies/2008/craexamination070808.pdf. [SEC Staff July 2008]

International Organization of Securities Commissions Technical Committee (IOSCO). *Report On the Subprime Crisis*. May, 2008. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf. [IOSCO Subprime Crisis May 2008]

International Organization of Securities Commissions Technical Committee (IOSCO). *The Role of Credit Rating Agencies in Structured Finance Markets*. May, 2008. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf. [IOSCO CRA May 2008]

President's Working Group on Financial Markets (PWG). *Policy Statement on Financial Market Developments*. March, 2008. http://www.ustreas.gov/press/releases/hp871.htm. [PWG March 2008]

Senior Supervisors Group (SSG). *Observations on Risk Management Practices in the Recent Market Turbulence*. March 6, 2008. http://www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf. [SSG March 2008]

United States Department of the Treasury. *Blueprint for a Modernized Financial Regulatory Structure*. March, 2008. http://www.treas.gov/press/releases/reports/Blueprint.pdf. [Treasury March 2008]

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Financial Services Roundtable (FSR). *The Blueprint for U.S. Financial Competitiveness.* November, 2007, http://www.fsround.org/cec/blueprint.htm.
[FSF April 2007 and October 2007]

United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century. *Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century.* March 2007.
http://www.uschamber.com/publications/reports/0703capmarketscomm.htm.
[Chamber of Commerce March 2007]

Mayor Michael Bloomberg and Senator Charles Schumer, with McKinsey & Company and New York City Economic Development Corporation. *Sustaining New York's and the US' Global Financial Services Leadership.* January, 2007.
http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.
[Bloomberg/Schumer January 2007]

Committee on Capital Markets Regulation (CCMR). *Interim Report of the Committee on Capital Markets Regulation.* November, 2006. http://www.capmktsreg.org/.
[CCMR November 2006]

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Name of Issuer	**Group of 30 (G-30)**
Name of Report	*Financial Reform: A Framework for Financial Stability*
Date of Report	January 15, 2009
Background of Issuer	"The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers." http://www.group30.org/

Objectives of the Report
The report considers how the financial system should be organized after the present crisis. It seeks a consensus on future arrangements that will be useful both in the long term and in restoring confidence in the present. The report examines the policy issues related to redefining the scope and boundaries of prudential regulation; the structure of prudential regulation, including the role of central banks, the implications for the workings of "lender-of-last-resort" facilities and other elements of the official "safety net," and the need for greater international coordination; improvements in governance, risk management, regulatory policies, and accounting practices and standards; and improvements in transparency and financial infrastructure arrangements.

Name of Issuer	**Committee on Capital Markets Regulation,**
Name of Report	Recommendations for Reorganizing the U.S. Financial Regulatory Structure
Date of Report	January 14, 2009
Background of Issuer	The Committee on Capital Markets Regulation is a not-for-profit research organization addressing issues in United States capital

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	markets. Its membership, focus, and activities are described at http://www.capmktsreg.org/index.html.

Objectives of the Report
Its 2009 report recommends "sweeping" changes in regulatory organization. The report focuses on the federal regulatory structure, not discussing—but stating the potential for commentary in a future report—on the role or states or self-regulatory organizations, internal agency organization, and global coordination.

Name of Issuer	**Robert Kuttner, prepared for Dēmos**
Name of Report	*Financial Regulation After the Fall*
Date of Report	January 9, 2009
Background of Issuer	Robert Kuttner, founder and co-editor of *The American Prospect*, prepared this paper for Dēmos. Dēmos is a non-partisan public policy research and advocacy organization headquartered in New York City.

Objectives of the Report
Kuttner writes that "This paper is an effort to catalogue abuses and suggest ways to think about regulatory remedies. Because of the continuing undertow of the market-fundamentalist ideology and the continuing political power of the very people and institutions that brought us this catastrophe, some of the most robust remedies will seem at the margins of mainstream debate. But, in order to move them to center stage where they can gain a proper hearing, it is necessary to at least inject these ideas into discussion."

Name of Issuer	**United States Government Accountability Office (GAO)**
Name of Report	*Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory*

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	System (GAO-09-216)
Date of Report	January, 2009
Background of Issuer	The United States Government Accountability Office (GAO) is an independent, nonpartisan agency that works for Congress. Its work is done at the request of congressional committees or subcommittees or is mandated by public laws or committee reports, and the GAO also undertakes research under the authority of the Comptroller General. http://www.gao.gov/about/index.html

Objectives of the Report
The Government Accountability Office report describes the origins of the current financial regulatory system, market developments and changes shaping the regulatory systems, and suggests issues to be addressed in designing and evaluating proposals for change. It describes structural gaps and stresses in the system rather than evaluates agencies' implementations of regulatory programs.

Name of Issuer	**North American Securities Administrators Association**
Name of Report	*Proceedings of the NASAA Financial Services Regulatory Reform Roundtable, December 11, 2008*
Date of Report	December 11, 2008
Background of Issuer	Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. NASAA is a voluntary association with a membership consisting of securities administrators in the fifty states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico http://www.nasaa.org/home/index.cfm

Objectives of the Report

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This document summarizes statements by state securities regulators in a discussion of regulatory reform designed to provide advice to the incoming administration of President Obama. The report stems from the NASAA's core principles for regulatory reform, found at http://www.nasaa.org/issues___answers/legislative_activity/9775.cfm.

Name of Issuer	**President's Working Group On Financial Markets (PWG)**
Name of Report	*Policy Statement on Financial Market Developments and Progress Update on March Policy Statement on Financial Market Developments*
Date of Report	March, 2008 and October, 2008
Background of Issuer	The President's Working Group on Financial Markets (PWG) consists of the Department of the Treasury, the Federal Reserve, Securities and Exchange Commission, and the Commodity Futures Trading Commission. The Treasury Secretary chairs the group. The PWG worked with the Office of the Comptroller of the Currency and Federal Reserve Bank of New York in preparing these reports.

Objectives of the Report
These policy statements offered recommendations to improve the future state of U.S. and global financial markets. The March statement addressed the causes of the market crisis and offered proposals to mitigate systemic risk, restore investor confidence, and facilitate stable economic growth. The October statement reviewed interim developments and provided a progress report on these initiatives.

Name of Issuer	**Group of 30 (G-30)**
Name of Report	*The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*

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Date of Report	October, 2008
Background of Issuer	"The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers." http://www.group30.org/

Objectives of the Report
In July 2007, the Group of 30 (G-30) commenced a seventeen-jurisdiction review of financial regulatory approaches. The G-30 Report outlines four approaches to financial supervision in use in jurisdictions around the world and assesses the strengths and weaknesses of each approach. Work on the October 2008 Report began before the current crisis, and thus it does not assess how different regulatory regimes performed in response to the crisis.

Name of Issuer	**Financial Stability Forum (FSF)**
Name of Report	*Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience and the Follow-Up on Implementation*
Date of Report	April 7, 2008 and October 10, 2008
Background of Issuer	The Financial Stability Forum (FSF), first convened in 1999, consists of senior representatives of national financial authorities, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. The FSF is serviced by a secretariat housed at the Bank for International Settlements. The FSF assesses vulnerabilities in the international financial system, identifies and oversees appropriate responses, and improves coordination and information exchange among the various authorities responsible for financial stability. It seeks to strengthen financial systems and the stability of international financial

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	markets, and any recommended changes are enacted by the relevant national and international financial authorities. http://www.fsforum.org/about/overview.htm

Objectives of the Report
In October 2007, the G7 Ministers and Central Bank Governors asked the Financial Stability Forum to analyze the causes and weaknesses producing the financial crisis and make recommendations by April 2008 to increase the resilience of markets and institutions. Collaborating in the work were the Basel Committee on Banking Supervision (BCSB), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centers. The FSF also drew on private sector participants. The follow-up report in October reviewed the implementation of the recommendations made in the April report.

Name of Issuer	**Basel Committee on Banking Supervision**
Name of Report	*Principles of Sound Liquidity Risk Management and Supervision*
Date of Report	September, 2008
Background of Issuer	The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. http://www.bis.org/bcbs/

Objectives of the Report

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Citing its review of banks' response to recent market turmoil, the committee faulted banks for failing to pay attention to basic principles of liquidity risk management. The committee found that many banks did not have an adequate framework in place to account for liquidity risks posed by products and business lines, causing incentives to be "misaligned" with overall risk tolerance. In an attempt to "underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process," the report contains principles and related best practices recommendations designed to increase banks' resilience to liquidity stress.

Name of Issuer	**Professor Lawrence A. Cunningham, for Council of Institutional Investors**
Name of Report	*Some Investor Perspectives on Financial Regulation Proposals*
Date of Report	September, 2008
Background of Issuer	The Council of Institutional Investors (CII) is a nonprofit association of public, union, and corporate pension funds with combined assets that exceed $3 trillion. Member funds are major long-term shareowners. Professor Lawrence A. Cunningham, author of the paper, is Henry St. George Tucker III Research Professor of Law at George Washington University Law School.

Objectives of the Report
Professor Lawrence A. Cunningham of George Washington University Law School wrote this paper for the Council of Institutional Investors (CII). It assesses, "from an investor's perspective," mutual recognition in securities regulation, integration of securities and futures regulation, and a model of financial regulation relying on a single agency to oversee all financial markets. The analysis examines the U.S. Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure*.

Name of Issuer	**The Counterparty Risk Management Policy Group (CRMPG) III**

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Name of Report	*Containing Systemic Risk: The Road to Reform*
Date of Report	August 6, 2008
Background of Issuer	The Counterparty Risk Management Policy Group III is a group of senior officials and staff from a number of major financial institutions. This is the third report prepared by the CRMPG focusing on improving risk management and financial infrastructure, with the earlier reports issued in 1999 and 2005.

Objectives of the Report
The CRMPG sets out a series of private initiatives intended to complement official oversight to help contain systemic risk. These include reconsideration of accounting standards for consolidation under U.S. GAAP of entities currently off balance sheet coming on balance sheet; measurement and management of high-risk financial instruments; improvements in risk monitoring and management; and measures to strengthen the resiliency of financial markets generally and the credit markets in particular, with a special emphasis on OTC derivatives and credit default swaps. The report also highlights important emerging issues.

Name of Issuer	**Institute of International Finance (IIF)**
Name of Report	*Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007–2008*
Date of Report	July, 2008
Background of Issuer	The Institute of International Finance, established in 1983 in response to the international debt crisis, is a global association of financial institutions. Its members include most of the world's largest commercial and investment banks and a growing number of insurance companies and investment management firms. http://www.iif.com/

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Objectives of the Report
The IIF Committee on Market Best Practices set out principles of conduct, best practice recommendations, and considerations for officials. The report examined risk management; compensation policies; liquidity risk; structured vehicles such as conduits and securitization; valuation; credit underwriting, ratings, and investor due diligence in securitization markets; and transparency and disclosure. The committee suggested that rigorous self-assessment and monitoring are necessary to improve conduct in each of these areas. However, higher industry standards can only work within an effective and efficient regulatory framework.

Name of Issuer	**Securities Industry and Financial Markets Association (SIFMA)**
Name of Report	*Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force*
Date of Report	July, 2008
Background of Issuer	The Securities Industry and Financial Markets Association (SIFMA) is a principal trade association of the financial services industry. Its membership consists of securities firms, banks, and asset managers. Its stated mission is to promote policies and practices to expand and improve financial markets, help to create new products and services and create efficiencies for member firms, and preserve and enhance the public's trust and confidence in financial markets and the industry.

Objectives of the Report
The Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force is a global task force formed to examine credit ratings and credit rating agencies (CRAs). It includes experts in structured finance, corporate bonds, municipal bonds, and risk and members from the United States, Europe, and Asia. The President's Working Group on Financial Markets (PWG) designated the task force as the private-sector group to provide the PWG with industry recommendations on credit rating matters. The task force identified the credit-rating-related causal variables contributing to the current crisis; ranked, in order of importance designated by its members, sixteen key issues; and addressed those issues in its recommendations.

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Name of Issuer	**United States Securities and Exchange Commission Staff**
Name of Report	*Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies*
Date of Report	July, 2008
Background of Issuer	United States Securities and Exchange Commission exercises regulatory jurisdiction over the credit rating process.

Objectives of the Report
In August 2007, the staff of the Securities and Exchange Commission conducted examinations of three leading credit rating agencies (CRAs) to review their role in market turmoil. The staff focused on the rating agencies' activities with respect to subprime residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) linked to RMBSs. In July 2008, the staff issued its summary report on issued identified by those examinations.

Name of Issuer	**International Organization of Securities Commissions Technical Committee (IOSCO)**
Name of Report	*Report on the Subprime Crisis*
Date of Report	May, 2008
Background of Issuer	The member agencies of the International Organization of Securities Commissions cooperate to develop and maintain high standards of regulation; exchange information on their respective experiences in order to promote the development of domestic markets; seek to establish standards and an effective surveillance of international securities transactions; and provide mutual

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	assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

Objectives of the Report
IOSCO's May *Report on the Subprime Crisis* identified causes of the market crisis and made recommendations to mitigate the current crisis and prevent such breakdowns in the future.

Name of Issuer	**International Organization of Securities Commissions Technical Committee (IOSCO)**
Name of Report	*The Role of Credit Rating Agencies in Structured Finance Markets*
Date of Report	May, 2008
Background of Issuer	The member agencies of the International Organization of Securities Commissions cooperate to develop and maintain high standards of regulation; exchange information on their respective experiences in order to promote the development of domestic markets; seek to establish standards and effective surveillance of international securities transactions; and provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

Objectives of the Report
Because of apparent failures in the credit rating process, the IOSCO Technical Committee asked its Credit Rating Agency Task Force to analyze the role CRAs play in structured finance markets and to recommend changes to the IOSCO CRA Code of Conduct as necessary. The May 2008 Report and related revisions to the IOSCO Code of Conduct for CRAs are the outgrowth of this effort.

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Name of Issuer	**Senior Supervisors Group (SSG)**
Name of Report	*Observations on Risk Management Practices in the Recent Market Turbulence*
Date of Report	March 6, 2008
Background of Issuer	The Senior Supervisors Group is composed of seven international supervisory agencies, including the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the U.K. Financial Services Authority, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve.

Objectives of the Report
In 2007 the Financial Stability Forum, which promotes international financial stability through information exchange and regulatory cooperation, initiated a study of risk management practices by firms preceding and during the financial crisis. The Senior Supervisors Group (SSG) surveyed eleven global banking organizations and securities firms in 2007 regarding their oversight and risk management, meeting with select firms' senior management in November 2007 and industry representatives in February 2008. Based principally on a survey and access to information on the firms' operations, it identified risk management practices differentiating firms' performance in weathering the crisis. Firms varied in how effectively their senior management team, business line risk owners, and control functions worked together to manage risks.

Name of Issuer	**United States Department of the Treasury**
Name of Report	*Blueprint for a Modernized Financial Regulatory Structure*

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Date of Report	March, 2008
Background of Issuer	The Department of the Treasury plays a central role in U.S. financial regulatory policy. For example, the Secretary of the Treasury chairs the President's Working Group on Financial Markets (PWG), currently consisting of the Treasury, Federal Reserve, Securities and Exchange Commission, and Commodity Futures Trading Commission.

Objectives of the Report
The Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure* calls for reorganization of the financial regulatory system. The work on the report began before the market downturn, so the *Blueprint* does not focus on many of the specific problems surfaced by the financial crisis, nor limits itself to proposing "emergency relief" for current economic ills. Rather, the *Blueprint* focuses on what it describes as regulatory gaps, redundancies and inefficiencies in the U.S. regulatory system and proposes broad reforms to the domestic regulatory regime.

Name of Issuer	**Financial Services Roundtable (FSR)**
Name of Report	*The Blueprint for U.S. Financial Competitiveness*
Date of Report	November, 2007
Background of Issuer	The Financial Services Roundtable is an organization of banking, securities, insurance, and investment organizations.

Objectives of the Report
The FSR Blue Ribbon Commission on Enhancing Competitiveness developed a set of Guiding Principles for what it called a more balanced, consistent, and predictable legal and financial regulatory system; articulated a financial services reform agenda based upon the application of the Guiding Principles to important legal and regulatory issues; and proposed changes in systems of chartering for existing financial services institutions. The Blueprint

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for U.S. Financial Competitiveness proposed ten policy reforms.

Name of Issuer	**United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century (the Commission)**
Name of Report	*Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century*
Date of Report	March, 2007
Background of Issuer	The Chamber of Commerce indicates that it is "the world's largest business federation, representing 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.... As the voice of business, the chamber's core purpose is to fight for free enterprise before Congress, the White House, regulatory agencies, the courts, the court of public opinion, and governments around the world." http://www.uschamber.com/about/default.htm

Objectives of the Report
The Commission stated that it "believes that with quick and decisive adjustments in the U.S. legal and regulatory framework, U.S. government regulators and market participants will be better positioned to ensure that U.S. investor and business interests are best served in the global marketplace. To better protect investors and promote capital formation, the Commission is setting forth a series of recommendations that would significantly improve the U.S. position in the global markets. These recommendations can be implemented quickly and without overly burdensome costs."

Name of Issuer	**Mayor Michael Bloomberg and Senator Charles Schumer, with McKinsey & Company and New York City Economic Development Corporation**

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Name of Report	*Sustaining New York's and the US' Global Financial Services Leadership*
Date of Report	January, 2007
Background of Issuer	To obtain a "comprehensive perspective" on the competitiveness of the U.S. financial services sector, with a particular focus on New York's contribution, Senator Schumer and Mayor Michael Bloomberg commissioned McKinsey & Company and the New York City Economic Development Corporation (NYCEDC) to interview business leaders, subject matter experts in regulatory, legal, and accounting professions, and investor, labor, and consumer groups.

Objectives of the Report
In their January 2007 report, New York City Mayor Michael Bloomberg and Senator Charles Schumer considered whether New York and the United States were at risk of ceding leadership in the financial services industry to international competitors. To obtain a "comprehensive perspective" on the competitiveness of the U.S. financial services sector, with a particular focus on New York's contribution, Senator Schumer and Mayor Bloomberg commissioned McKinsey & Company and the New York City Economic Development Corporation (NYCEDC) to interview business leaders, subject matter experts in regulatory, legal, and accounting professions, and investor, labor, and consumer groups.

Name of Issuer	**Committee on Capital Markets Regulation (CCMR)**
Name of Report	*Interim Report of the Committee on Capital Markets Regulation*
Date of Report	November, 2006
Background of Issuer	The Committee on Capital Markets Regulation is a not-for-profit research organization addressing issues in United States capital markets. Its membership, focus, and activities are described at http://www.capmktsreg.org/index.html.

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Objectives of the Report
The Interim Report articulated concerns regarding the impact of regulatory policy and private litigation on United States capital markets.

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AFL-CIO Executive Council Statement
Chicago, Illinois, August 8, 2007

Private Equity and Hedge Funds

In the past year, the global labor movement has mobilized to address the issue of what John Monks, president of the European Trade Union Confederation, has labeled the "financialization" of the global economy.

Financialization describes the growing dominance of finance over the real economy, and, in the United States at least, over politics as well. At the heart of financialization are the growing size and power of hedge funds and leveraged private equity funds—leveraged private pools of capital that benefit from extensive tax subsidies and are unregulated and shrouded in secrecy.

The AFL-CIO has long favored greater investor protections and regulatory oversight of hedge funds, as the Executive Council reaffirmed in its statement last March. However, the recent dramatic growth in both leveraged private equity and hedge funds has made it necessary to state the labor movement's views on the challenges these funds pose to policy makers, to workers and their unions and to fiduciaries entrusted with workers' capital.

Leveraged buyout funds and hedge funds have been around for years and are not going to disappear. Pension funds and other institutional investors have used them properly in modest amounts to help round out their portfolios and offset the volatility of other investments. But it is both dangerous and illusory to believe that pension funds in general can achieve sustained above-market rates of return for large portions of their portfolios by investing in leveraged asset pools. And there is no reason why these funds should be secretive or unaccountable. Finally, there is no reason why the individuals who manage private equity and hedge funds should receive tax subsidies that leave the burden of paying ordinary tax rates to working people.

It is easy to generate high returns to equity with a combination of cheap debt financing and tax subsidies. That is not a long-term strategy, nor does it require genius—and there is a real cost. There is a hidden cost to the investors who are paying for the leverage with risk, a real cost to workers and their companies that are managed for short-term return and a real cost to the rest of us who subsidize the massive redistribution of our wealth and tax dollars to billionaires.

While leveraged buyouts can provide needed capital to troubled companies, a mania for leveraged finance sets in motion a dynamic in which companies are acquired and hollowed out to make them appealing candidates for being flipped back into the public markets. Workers' jobs, their health and retirement benefits and, in the end, their communities are nothing more than costs that can be converted into debt repayments. America's workers experienced this dynamic in the late 1980s, and now we are experiencing it again.

In response, the AFL-CIO's policy on private equity and hedge funds addresses government policy makers, pension fund fiduciaries and private equity and hedge fund managers themselves.

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First, policy makers should enforce our existing laws, protect investors and, most of all, ensure that our tax system is fair. Private pools of capital should be required to play by the same set of rules as everyone else. The Securities and Exchange Commission should enforce the Investment Company Act and require private equity and hedge funds that wish to sell interests in their underlying investment pools to register as investment companies.

The IRS should look into self-dealing tax avoidance schemes by private equity funds and hedge funds going public. The IRS and the SEC should investigate whether the positions taken by these funds going public with each agency are mutually consistent.

The AFL-CIO strongly endorses both the Grassley-Baucus bill, S.1624, and the Levin-Rangel bill, H.R. 2834. The Grassley-Baucus bill requires private equity firms and hedge funds that go public to either provide investors with the protections they are entitled to under the Investment Company Act or pay corporate taxes on their earnings, while the Levin-Rangel bill requires hedge fund and private equity managers to pay ordinary income tax rates on their wages like any other American. We commend the authors and co-sponsors of these bills for their leadership in this area, together with those in Congress who have asked the regulators to enforce the existing tax, investor protection and national security laws. Both bills are badly needed correctives to a tax system that has become grossly unfair.

The AFL-CIO calls upon politicians who think billionaires should have lower tax rates than firefighters and teachers to explain why they deserve the votes of working people.

The AFL-CIO recommends that fiduciaries exercise great care in investing workers' capital in leveraged or opaque private investment vehicles. We urge fiduciaries to invest only in hedge funds that are registered with the SEC as investment advisors, and to ask hedge fund managers to agree to be bound by key protective provisions of ERISA. Some funds also have adopted policies that address the workplace practices of private equity and their impact on long-term value creation.

We particularly urge fiduciaries to work with their asset consultants to ensure the total exposure to either of these categories is modest and the expectations in relation to long-term risk-adjusted returns are realistic.

Finally, the AFL-CIO calls upon the hedge fund and private equity industries to act responsibly—to engage in dialogue both in the United States and globally around investor protection, taxation and workers' rights in the companies they control and influence. There are models for responsible behavior—leveraged buyout firms with a significant history of working productively with workers and their unions, both in the United States and overseas, generating healthy returns while preserving jobs and treating workers with respect.

We particularly urge the industry to engage in a dialogue around investor protection, tax fairness and workers' rights with the global labor movement. America's workers and their unions stand in solidarity with our brothers and sisters around the world in facing the challenge of financialization.

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AFL-CIO Executive Council Statement
San Diego, California
March 5, 2008

DELUSIONS OF WEALTH: FINANCIALIZATION, FINANCIAL MARKET DEREGULATION AND THE CREDIT CRISIS

The housing and credit crisis is the direct consequence of a 30-year experiment in trying to have the impossible: a low-wage, deregulated economy with high consumer spending. Long-term solutions must address how to restore the economic health of the American middle class through good jobs, health care, retirement security and a voice at work for all. But part of the solution must be the thoughtful, comprehensive re-regulation of the financial markets.

The AFL-CIO has long favored greater investor protections and regulatory oversight of participants in the U.S. financial markets. As we meet, much of the mortgage market, the municipal bond market, the market for risky corporate debt and in the last week the student loan market is frozen—the result of a massive loss of confidence in the information available to investors. Only thoughtful re-regulation can restore that confidence and unlock the markets.

The damage to working families is real, and growing. Working people are losing their homes at an alarmingly rate. Jobs in construction are disappearing. And workers' pension funds have suffered tens of billions of dollars in losses from their investments in financial services companies and housing-sector companies battered by subprime losses.

Reining in financial intermediaries after a 30-year free-for-all will be a complex task requiring coordinated action involving Congress and regulators at both the state and federal levels, and increasingly international regulatory action. Given the irresponsible attitude of many in the Bush administration, we must assume that only the first steps will be possible while that administration remains in office.

Effective regulation must be implemented to ensure the transparency and accountability of mortgage lenders, investment banks, credit-rating agencies, hedge funds, private equity funds, off-balance-sheet lending vehicles and other structured credit products, as well as Sovereign Wealth Funds (SWFs). The AFL-CIO has called repeatedly for transparency and clear fiduciary duties to investors by all pools of private capital large enough to present issues of systemic risk. The reason for such transparency has never been clearer.

The AFL-CIO also has warned repeatedly of the danger of market accounting in contexts where there are no functioning markets or where such accounting can contribute to a downward economic spiral unrelated to the actual business activity of companies. We are now living through the circumstances we foresaw.

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As a first step, policymakers must revisit the fundamental risk that exists when fee-based investment banking is combined with the business of taking and investing insured deposits. The repeal of the Glass-Steagall Act by the Gramm-Leach-Bliley Act appears to have left this dangerous problem effectively unregulated. In particular, Congress and the regulators must address executive compensation structures that reward excessive risk-taking with federally insured deposits. Regulators here and around the world must deal with the fundamental problem that if a lender can pass off bad loans to an unsuspecting public in securitizations and keep none of the risk and collect the fees, the lender has no incentive not to make the bad loan in the first place. The AFL-CIO supports the effort of House Banking Committee Chairman Barney Frank to work on these issues on an international basis with the European Parliament.

Credit-rating agencies that gave securitized subprime loans triple A ratings are one of the major causes of this debacle. Congress needs to increase the Securities and Exchange Commission's power to regulate these agencies, possibly through an independent body like the Public Company Accounting Oversight Board created by the Sarbanes-Oxley Act.

Like all investors that rely heavily on borrowing to finance their investments, hedge funds and private equity funds will suffer as lenders tighten their standards. The high-profile failures of leveraged buyouts led by prominent private equity firms including Blackstone and J.C. Flowers are indicative of the difficulties ahead. As we have said in the past, Congress should act (1) to give the regulators power in this area to protect investors and (2) to ensure that our tax system is fair by taxing hedge fund and private equity fees at ordinary income rates.

As a result of nearly three decades of self-destructive trade and energy policies, our trade deficit has given birth to the SWFs. Our flagship financial institutions, crippled by their catastrophic involvement in the subprime markets, have been bailed out by these funds. Our economy has come to depend on flows of foreign capital, and we cannot look to exclude such funds from our markets or disadvantage their rights as investors. Nonetheless, we strongly support the efforts of Sens. Jim Webb, Charles Schumer and Evan Bayh to address the challenges posed by the rise of SWFs.

Specifically, SWFs should be required to comply with all of the disclosure requirements that apply to domestic investors. By removing provisions that allow foreign investors to escape government review when shares are non-voting, Congress should also lower the ownership level that triggers optional governmental review from 10 percent to 5 percent and revise the laws to acknowledge that 5 percent ownership of a company allows a shareholder substantial influence over the board regardless of whether it has voting rights.

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Not all SWFs are the same. Norway's Government Pension Fund provides retirement security for all Norwegians and is a leader in efforts at transparency in the global capital markets. The Norwegian fund should be looked to as a model of the transparency and accountability we should expect from all SWFs.

Re-regulation will not by itself restore our economy to health. That will require middle class restoration. But thoughtful re-regulation of financial markets is part of what must be done. We urge Congress and the regulators to act without delay to address the conflicts within financial institutions, bring transparency to opaque pools of capital, and protect consumers and the public interest in the capital markets.

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Testimony of Robert C. Pozen
Senate Committee on Homeland Security and Governmental Affairs,
On the Need for a Systemic Risk Regulator

March 4, 2009

Mr. Chairman and Other Members of the Senate Committee:

I am Robert Pozen, Chairman of MFS Investment Management of Boston, Massachusetts. MFS manages mutual funds and pension assets for five million investors across the world. I am also a senior lecturer at Harvard Business School, where I teach courses on corporate governance and financial intermediation.

Thank you for this opportunity to testify before this Senate Committee on the need to monitor systemic risk and, if so, the best way to meet this need. I applaud the Committee for addressing this important subject at this critical time.

Systemic risk can be defined as the risk of a broad-based breakdown in the financial system – for example, where the failure of one large financial institution leads to the failure of others. Immediately below is a summary of my five main points. Then further below is the support for each of these points.

Summary

1. The United States needs one federal agency to play the role of systemic risk regulator because of the increasing frequency of global financial crises and higher correlations among different investment markets.
2. Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system.

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3. The Federal Reserve Board should focus on five areas that are likely potential sources of systemic risk – inflated prices of real estate, institutions with high levels of leverage, new products falling into regulatory gaps, rapid growth in an asset class or intermediary and mismatches of assets and liabilities.

4. The Federal Reserve Board should monitor closely the activities of all types of financial institutions with very large or otherwise very risky assets since they are the ones most likely to impact the whole financial system.

5. If the Federal Reserve believes that actions need to be taken to reduce systemic risks, it should work closely with the regulatory agency with primary jurisdiction over the relevant institution, product or market.

Supporting Analysis

1. The United States needs one federal agency to play the role of systemic risk regulator because of the increasing frequency of global financial crises and higher correlations among different investment markets.

Within the last decade, we have witnessed two major financial crises in addition to the current one. The first was the Asian financial crisis in 1997-1998, which led to the Russian default on its ruble bonds and the near demise of Long-Term Capital, a large hedge fund. The second was the burst of the dot.com bubble in the United States, which led to a general decline in global stock markets in 2000 through 2002. More generally, Professor Barry Eichengreen of the University of California at Berkeley found 38 worldwide financial crises between 1945 and 1971, as compared to 139 financial crises between 1973 and 1997. Of these 139, 44 took place in high income countries.

In my view, the rate of global financial crises is likely to stay high or increase. The rapid pace of innovation in financial products presents a formidable challenge to all financial regulators. The low cost of financial transactions makes it easy to quickly

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expand the trading volume in any security. Most importantly, the widespread globalization of finance has led to much higher correlations among different national stock markets and assets classes. In order to facilitate coordination among international financial agencies, it would be very useful to have one systemic regulator in the US.

2. Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system.

The doctrine of "too big to fail" used to apply only to banks because they are insured by the FDIC. Over the last year, however, the federal government decided that AIG, an insurance company, and Bear Stearns, an investment bank, should be bailed out by the Federal Reserve Board. After the failure of Lehman Brothers wreaked havoc in the short-term lending markets, it seems clear that the Federal Reserve Board will be asked to bailout any type of financial institution whose failure would threaten the whole financial system. If the Federal Reserve Board is going to bailout a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure.

In addition, the Federal Reserve has a substantial portion of the resources and expertise necessary to monitor risks in the whole financial system. As part of its current functions, the Federal Reserve Board monitors economic indicators in the US and abroad. The Federal Reserve Board also has long experience in regulating banks and their holding companies. However, to be an effective systemic risk regulator, the Federal Reserve Board will need to develop significantly more expertise on capital markets and non-banking institutions. Because the Federal Reserve would be taking on broad new responsibilities, perhaps the function of setting mortgage disclosure rules should be transferred to a federal agency with a consumer protection mandate.

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3. The Federal Reserve Board should focus on five areas that are likely potential sources of systemic risk – inflated prices of real estate, institutions with high levels of leverage, new products falling into regulatory gaps, rapid growth in an asset category or intermediary and mismatches of assets and liabilities.

While the Federal Reserve Board should look broadly at the whole financial system, it should focus on the five factors historically associated with financial crises in advanced economies. In Europe, Japan and the United States, financial crises have often started with sky-high prices of commercial and residential real estate financed by a credit boom. When those prices become unsustainable, the real estate market crashes. A real estate crash now reverberates through the financial system since so many mortgages are securitized and sold to investors.

Institutions with very high leverage ratios have the potential to cause a ripple effect throughout the financial system. For example, if an institution has $100 billion in debt and only $3 billion in capital, its capital can be reduced to zero if only a few of its large investments sour. Then it will be forced to sell billions of dollars of its assets to meet its debt obligations. These forced sales are likely to drive down prices for assets held by other financial institutions, which may in turn incur losses and start to sell assets.

As new financial products and institutions evolve, they can sometimes fall within the cracks of the regulatory system. A good example is a credit default contract, which was declared not to be an insurance or futures contract in 2000. Without a federal regulatory framework, the volume of credit default contracts soared and exceeded $50 trillion by 2007. The Federal Reserve Board should monitor new products to close any regulatory gap before a systemic risk is created.

Similarly, if an asset class or intermediary experiences explosive growth, the Federal Reserve Board should understand the reasons for that growth. Between 2002 and

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2006, for instance, there was a huge increase in the volume of new types of mortgage backed securities issued by off-balance sheet entities. We should have examined whether that rate of growth was sustainable.

A final indicator of systemic risk is a mismatch between long-term assets and short-term liabilities; this presents a fundamental challenge to institutional liquidity. In the S&L crisis, their assets were mainly long-term mortgages with fixed rates, but their liabilities were mainly short-term deposits with periodically changing rates. When deposit rates rose and mortgage rates stayed fixed, S&Ls became insolvent. In the current financial crisis, mismatches were again created by bank sponsors of special purpose entities, which sold short-term commercial paper to investors to finance long-term mortgages held by these entities. When investors became unwilling to roll over the commercial paper every 90 or 180 days, the bank sponsors were forced to provide liquidity support for these entities.

4. The Federal Reserve Board should monitor closely the activities of all types of financial institutions with very large or otherwise very risky assets since they are the ones most likely to impact the whole financial system.

The Federal Reserve Board should not confine its monitoring activities to banks; it should monitor any type of financial institution that is likely to create systemic risks. These are typically the very largest firms in each institutional category, although the correlation between size and risk may not hold in certain institutional categories. These categories include insurance companies, securities firms, pension plans, money market funds and hedge funds. For the small group of relevant firms in each category, the Federal Reserve Board should receive regular reports on their solvency and liquidity risks since they are likely to be granted access, if needed, to its discount window.

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All these types of financial institutions already have a primary regulator, except for hedge funds. In my view, the managers of hedge funds over a certain size (e.g., $100 million in assets) should be required to register with the SEC under the Investment Advisers Act of 1940. Such registration would not limit their investment strategies or prevent them from charging incentive fees to wealthy clients. In addition, a handful of very large hedge funds (e.g., over $100 billion in assets) should submit to the SEC non-public reports with information relevant to systemic risks – e.g., leverage ratios and short positions – which would be passed on to the Federal Reserve Board.

It bears emphasis that the Federal Reserve and the primary regulator should keep confidential which specific institutions are being monitored for systemic risk. The public announcement that an institution is being monitored might lead investors incorrectly to assume that it will always be bailed out by the Federal Reserve Board. Conversely, investors might be unduly alarmed if they learn that an institution is being added to the monitoring process.

5. If the Federal Reserve believes that actions need to be taken to reduce systemic risks, it should work closely with the regulatory agency with primary jurisdiction over the relevant institution product or market.

The Federal Reserve Board should not become the primary regulator of very large hedge funds or other non-banking institutions. The Board has enough on its plate without taking on the general supervision of other types of financial institution, especially if there is a primary regulator with the relevant expertise. The Board should remain the primary regulator of state member banks and all bank holding companies.

If the Federal Reserve Board believes that it is necessary to limit the risks of a particular institution or product, it should explain its position to the relevant primary regulator. The primary regulator and the Board can then work together to impose the

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necessary limits through appropriate measures. If the primary regulator and the Federal Reserve cannot agree on a course of action, the dispute should be resolved by the President's Working Group on Financial Institutions.

In addition, the FDIC should be given the power to supervise the bankruptcy proceeding for any systematically large financial institution. When Lehman Brothers became insolvent in 2008, it went through the normal bankruptcy process. This hindered federal regulators in dealing with the systematic ramifications of Lehman's failure.

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Thank you again for this opportunity to testify before this Senate Committee. Please feel free to ask any questions you might have.

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Testimony of David Green
Former Head of International Policy, Financial Services Authority, UK

before the Committee on Homeland Security and Governmental Affairs
United States Senate

Hearing on Financial Regulatory Lessons from Abroad

21st May 2009

My name is David Green. I give testimony as a private individual, drawing on my work experience at the Bank of England, UK Financial Services Authority and UK Financial Reporting Council, and as co-author with Sir Howard Davies of a book entitled "Global Financial Regulation: The Essential Guide (Polity Press 2008). The views I express here are entirely my own and not those of any of the organisations with which I have been associated.

There is remarkable bio-diversity in arrangements for financial regulation at a global level, with no two G7 countries having quite the same structure. There are essentially four main types of structure to be found, with multiple variants. There is the sectoral type, with separate regimes for banking, securities and insurance, which can be found in eg France, Italy or Spain. There is the so-called "twin peaks" type to be found in Australia or, in alternative versions, in The Netherlands or Canada; the integrated type, versions of which can be found in Germany, Japan and Scandinavia, as well as the UK; and a fourth type, which might be described as "other", of which the prime example is the US, with its extraordinary complex of agencies at both state and federal level. In each case the central bank may or may not have responsibility for some, many or all aspects of supervision.

Although integrated regulators have existed in a number of countries for several decades, the creation of the FSA in 1998 produced perhaps the most advanced form of that model, although variants of the integrated regulator model continue to be introduced and are now in place in more than forty countries. By "integrated" I mean a regulator that deals with banking, insurance, asset management and market supervision and regulation, all within a single agency. This is by comparison with arrangements whereby there are completely separate agencies dealing with each of these sub-sectors or with the "twin peaks" model, under which there is partial integration, usually with a separation between, on the one hand, the safety and soundness regulation, or what in the UK we call the prudential regulation of banking and insurance and, on the other, conduct of business regulation, usually, though not always, solely in relation to securities and investment business.

The FSA was created remarkably rapidly when the incoming Labour Government decided in 1997 that, at the same time as giving the Bank of England independence

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in the implementation of monetary policy, it would also create a single regulator for financial services. At the time no systematic review had been undertaken of what was needed and some of the factors leading up to the decision were of purely local, national concern, arising, for instance, from a previous unsatisfactory and duplicative structure in the regulation of investment services and partly from perceived shortcomings believed to arise from the location of banking supervision in the central bank. Indeed, the rationale behind creating an integrated regulator was only fully developed in the course of the FSA's creation.

The merger that was set in train, and which eventually comprised 11 organisations, also involved the drafting of a single piece of comprehensive legislation. This new legislation incorporated fresh thinking about the ultimate objectives of financial regulation and the principles that should guide its exercise. Not all integrated regulators operate with a single integrated piece of legislation, but instead maintain separate sectoral legislation while still placing the management of the staff who undertake the regulation under a single roof in order to promote co-ordination, consistency and efficiency.

In the UK case, the merger of the staff was undertaken in practical terms within an eighteen-month period, but the implementation of the legislation followed almost three years later. In the meantime, the form of the old legislation was observed, while the substance of the new body was being planned and implemented. No significant part of the infrastructure of any one of the existing regulators was used for the new body, as it would have created the impression that one body was taking over the others. A key success factor for the new organisation was identified at the outset as being the creation of something built organically by its members and it was not possible to identify the pre-existing regulators within the new structure once it was completed.

In the period following the establishment of the FSA, it published a member of papers setting out the rationale for integrated regulation.

The main arguments advanced were as follows: -

1. The growth of financial conglomerates undertaking a range of banking, insurance and investment businesses poses a challenge to sector-based regulation. The growth in the number of financial conglomerates has been accompanied by a blurring of the boundaries between products, and channels of distribution are no longer as specialised as they once were. It is now difficult to regulate on a functional basis, since a traditional functional approach no longer matches the structure of either firms or markets.

2. This points to a need for regulatory oversight of a financial conglomerate as a whole since there may be risks arising within the group that are not adequately addressed by any of the specialised supervisory agencies that undertake their work on a solo basis.

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3. It is possible to solve this problem through a lead regulator approach, whereby one agency takes responsibility for the co-ordination of the work of others, but a single regulator offers a number of advantages. In particular, it ought to be able to generate a number of efficiency gains; there are economies of scale and scope because a single regulator can, as well as utilising a single set of support services, also unify statistical reporting and construct a consolidated set of rules and guidance.

4. Integration of the regulatory functions makes it possible to align the regulatory structure with the way the firms manage themselves. This should help with the proper understanding of the overall business model and of its risks. Earlier experience pointed to instances where the divide between conduct of business and prudential regulation was unhelpful to understanding the complete picture.

5. A regulated firm only needs to deal with one agency for all its regulatory business, ideally through relationship managers on both sides.

6. In addition to scale economies, a single regulator ought to be more efficient in the allocation of regulatory resources across both regulated firms and types of regulation. This requires a risk-based approach to supervision under which resources are devoted to those firms and areas of business that from time to time are seen as posing the greatest risk. This allocation and reallocation of resources to deal with changing demands can be more actively undertaken within a single authority, though it requires continuous attention to make sure emerging risks are not neglected.

7. A single regulator ought to be best able to resolve efficiently and effectively the conflicts which inevitably arise between the different objectives of regulation. These are generally taken to be prudential soundness and the maintenance of confidence, on the one hand, and transparency and consumer or investor protection on the other. This approach does not deny that tensions or even conflicts may exist, but argues that these tensions have to be resolved in one way or another. This needs to be done both at the regulator level and also within a firm. A breakdown in consumer protection, whether in banking, investment or insurance products, may itself precipitate a wider loss of confidence in types of product or types of firm. A failure to understand the financial implications of the structure of particular products can also threaten safety and soundness. In the long run, these two aims are aligned. The UK had already had experience of problems arising from the uncoordinated pursuit of objectives by regulators when they were separated, which in one case may have led to the unnecessary failure of a bank. Recent experience also suggests that conflicts have had to be settled in countries where the responsibilities are separate in

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ways that have led to one or other of the regulators effectively suspending pursuit of their responsibility until a resolution was reached.

8. A single regulator strengthens accountability. It can be made solely responsible for its performance against statutory objectives, for the regulatory regime, for the cost of regulation and for regulatory failures.

Clearly, another set of issues is related to the decision to remove responsibility for banking supervision from the central bank. The arguments against combining monetary policy and banking supervision included:-

1. There might be a conflict of interest which tempted a central bank to loosen its monetary policy stance (or to delay a monetary tightening) because of concerns about the financial health of the banks it regulates.

2. A loss of credibility arising from perceived regulatory failings may damage the central bank's reputation, and therefore its authority to conduct monetary policy.

3. The wider role of a central bank and the more it takes on regulatory responsibilities which inevitably involve the disposition of property rights, the greater the risk that it would be subject to political pressure or political control which may undermine its independence in respect of monetary policy. It could be difficult to manage two different types of accountability relationship with Government and Parliament within the same institution, namely, independence in respect of the implementation of monetary policy, but accountability in respect of the supervision of banks.

4. There was an argument for the separation of lender of last resort from supervision responsibilities, on the grounds that a lender of last resort which is also responsible for ongoing supervision may be tempted to intervene in support of an institution to cover up the inadequacy of its own supervision. Furthermore, involving two agencies in the decision of whether to rescue an individual institution may improve the quality of decision-making.

5. The putting of banking supervision into the central bank involves the separation of banking supervision from the rest of regulation, depending on which other functions are also included in the central bank, with the comsequent disadvantages outlined earlier.

These points are, in comparative terms, more difficult to substantiate than the arguments in favour of the integration of the different supervisory disciplines.

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Given the decision to create an independent integrated regulator and to leave the implementation of monetary policy with the central bank, another key element in the UK arrangements was a tripartite Memorandum of Understanding setting out the roles of each of the FSA, Bank of England and Treasury. This acknowledged the different functions of the regulator, the central bank as monetary policy-maker and manager of last resort lending, and Treasury as provider of fiscal support and, in the UK context, ultimate proposer of legislation.

The FSA structure is not entirely comprehensive in that it does not encompass the regulation of pensions, where a new regulator had recently been established, and with most pension funds closely linked to non-financial employers. Nor does it incorporate corporate reporting.

The main elements in corporate reporting were progressively brought under the separate single roof of the Financial Reporting Council over more than a decade. Unlike in the case of the FSA, the legislation for the different elements of the regulation of corporate reporting have not been integrated and they remain the responsibility of formally independent decision-making boards, not all with full statutory authority, but served by a single secretariat and with one over-arching board.

The functions housed under the Financial Reporting Council roof are the maintenance of the non-statutory corporate governance code, the setting of accounting, auditing and actuarial standards, the public oversight and inspection of the auditing and actuarial professions and the related exercise of enforcement and discipline. [A full account of how these arrangements work can be found in the FRC's Regulatory Strategy, to be found on the FRC's website, www.frc.org.uk]. Although there is no statutory objective for the constituent operating bodies under the Financial Reporting Council to seek to implement an integrated regulatory approach, the fact of being under a common roof supports the adoption of mutually consistent approaches where this is appropriate. The FRC model has not been precisely replicated in any other country, but has attracted a lot of interest, including in the US.

I have been asked to comment on how the integrated model has stood the test of time in the UK. In the period up to the start of the financial crisis in 2007, the UK model was widely praised both domestically and internationally. Since the onset of the crisis regulation in the UK has been widely criticised, as it has been in the US and elsewhere. Some of those criticisms have in effect been targeted at the international rules on bank capital; others have been related to other causes, including the structure of regulation. Some have argued that the separation of banking supervision from the Bank of England was a mistake, reducing the central bank's understanding of banking and financial markets.

The FSA has acknowledged in the case of the failed bank, Northern Rock, that it did not always do what it was supposed to do, or even follow its own internal

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procedures, and it has published probably the most comprehensive report by any authority anywhere so far in the crisis about how this happened and what it will do to prevent similar shortcomings in the future.

There have been shortcomings in analysis and failure to understand the full implications of changing market structures and changing business models, but failure either to fully understand the implications or to act on such analysis has been a feature of each of the different regulatory models. The FSA has also produced its own review on how to respond to these shortcomings [The Turner Review-A Regulatory Response to the Banking Crisis. March 2009. www.fsa.gov.uk]. And there have been failures of communication between the regulator, central bank and government. This has been much discussed, although no definitive analysis has been produced.

The main structural lesson to be drawn has been that the FSA needs to be more alert to wider developments in the economy and in markets as they affect the firms it regulates, and that the central bank needs to be more alert to developments in the financial system as the financial system is the only medium through which monetary policy is transmitted to the economy. Some have argued in an imprecise way for banking supervision somehow to be separated out of the FSA and returned to the central bank, but this has not received serious, considered support.

In short, the crisis has not generated any serious questioning of the integrated model. Indeed, it has illustrated rather clearly the interlinkages between banking, investment and securities, which was one of the prime causes of the creation of the FSA. Both the Bank of England and the FSA [see eg Turner Review pp 89-92] have examined the question as to which kind of regulatory model performed best internationally under the stress of the present crisis, but have found no pattern in the outcomes. Just to take a small number of examples, both Spain and Canada have been relatively successful in weathering the crisis, yet Spain operates sectoral supervision, with banking supervision located in the central bank, while Canada has an integrated prudential regulator with no central bank involvement. In contrast, both the UK and the US underwent considerable difficulty, with the FSA operating an integrated regime outside the central bank, but the US entrusting a major sectoral role in banking supervision to the Federal Reserve.

It has been suggested that I comment on proposals for reform in the US. The new Administration has yet to fully set out its own proposals for reform so that former Secretary Paulson's blueprint remains the most closely articulated model. Clearly, the existing structure derives from the very distinctive historic and political background to the evolution of regulation in the US, including notably the federal structure. Having local and state levels of responsibility and accountability brings its own strengths. Nonetheless, viewed from outside, there seems clear need for major reform. The Paulson blueprint addresses the most evident anomalies; the absence of a federal structure for insurance supervision and the division of competence in the securities and derivative markets between the SEC and CFTC.

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As has been widely commented, the Paulson blueprint appears to have closest resemblance to the Australian model. Clearly the arguments referred to earlier about whether to integrate conduct of business and prudential regulation are relevant here and others, such as Prof. Howell Jackson of Harvard, have argued instead for a rapid move to a fully integrated structure of regulation, very much for the motives outlined earlier [Howell E. Jackson. A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States. London School of Economics Financial Markets Group Special Paper 184].

The most imprecise part of the Paulson blueprint seems to be the separation between the Federal Reserve's role in relation to systemic risk and that of the functional regulators. While it is possible, indeed desirable, to undertake analysis of system-wide issues - so-called macro-prudential analysis –, supervision only takes place at the level of each individual firm or market. It would make for confusion if the systemic agency became responsible for matters that overlapped with the responsibilities of the functional regulator, whether prudential or conduct of business, and this would need to be resolved. One way of resolving this could be to create an integrated regulator just for systemic firms, perhaps building along the lines foreshadowed recently by Secretary Geithner, but that would then raise level playing field and efficiency issues in relation to the regulation of non-systemic firms for which some further mechanism would be needed.

A single regulator for the US financial market on the UK model would be both an extremely large and an extremely powerful institution, perhaps too powerful in the US political context. It is also difficult for an outsider to comment on how best to deal with the overlapping jurisdiction of federal and state governments. Clearly, there are very many major issues over jurisdiction, both between the federal government and the states, and within the Congress itself. Nevertheless, the outside observer is inclined to feel that there must be substantial costs to the US economy in these arrangements, which even partial rationalisation would mitigate. Both gaps and overlaps are important and the proposition advanced recently by the administration that regulation should focus on what financial firms do and no longer on the legal form they take in order to determine who will regulate them makes a fundamental point in relation to regulatory reform. This proposition is advanced in the context of creating a single regulator with responsibility over systemically important firms, but it would make a sound starting point for reform in financial regulation as a whole.

Thank you for your attention. I look forward to seeking to respond to your questions.

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Regulation by Objective – The Australian Approach to Regulation

Statement to the US Senate Committee on State Homeland Security and Governmental Affairs

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21 May 2009

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Regulation by Objective – The Australian Approach to Regulation

In 1996, the Australian Government commissioned a committee to review the Australian experience with financial deregulation, to assess the forces for change in the financial system over the coming decade or so, and to recommend a regulatory architecture that would best cope with these changes.

The Financial System Inquiry Committee (known informally as the Wallis Committee) reported in March 1997 with 115 recommendations ranging from the competitive structure of the financial system to detailed legislative changes. The Australian Government implemented all but a few of these recommendations. At the core of these recommendations was a proposal to realign the then-existing hybrid structure of multiple, institutionally-based prudential regulators and product-based conduct and competition regulators into a consolidated group of regulators based on regulatory objectives.

The primary motivation behind the proposal was to make regulation more effective. In particular, there was a desire to better regulate financial conglomerates and to minimize regulatory arbitrage (to ensure that institutions selling the same financial products are subjected to the same regulatory requirements).

The Committee was conscious of the reality that a sound regulatory architecture is a necessary but not a sufficient condition for effective regulation. Effective regulation requires strong powers, best-practice rules and standards, appropriate skills, a flexible risk-focused approach to supervision, and acceptance by regulators, government, and the community generally of the need to take enforcement action against institutions and individuals who do not comply with the law. Without a supportive regulatory architecture, implementing these first-line strengths can be undermined to the point of ineffectiveness. By the same token, a sound architecture without the necessary tools, skills and commitment is also doomed to failure.

The particular shape of the architecture recommended by the Committee was unique in the world at the time and reflected a balancing of many considerations.

The underlying philosophy adopted by the Committee was that regulatory intervention can only be justified if it addresses market failure. In general, markets function most efficiently without regulatory interference. The reality, however, is that markets can fail for a variety of reasons. The decision to intervene to alter the natural functioning of a market through regulation should be justified on the grounds that the cost of the market failure is greater than the costs imposed by regulation (either direct resource costs or losses of efficiency).

In broad terms, the Committee agreed that financial markets fail to produce efficient, competitive outcomes for one or more of four main reasons.

First, individuals or companies may engage in anti-competitive behaviour, such as collusion or market dominance. The role of competition regulation is to ensure that market forces operate effectively and are not circumvented by market participants.

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Second, as much as we wish it were not so, there are individuals and firms that are prepared to cheat, defraud, misrepresent products, and manipulate markets to their own advantage. While this may occur in any market, this type of misconduct is especially egregious in financial markets where products are complex, the stakes are often high (possibly involving an individual's entire lifetime savings), and the evidence of misconduct is often easily hidden for long periods. For financial markets to operate efficiently and effectively, participants must act with integrity and there must be adequate information on which to make informed judgements. For these reasons, conduct regulation focuses on setting and enforcing standards of disclosure and conduct in dealing with clients and investors.

The third source of market failure, information asymmetry, arises where products or services are sufficiently complex that disclosure by itself is insufficient to enable consumers to make informed choices. This form of market failure should be distinguished from market misconduct associated with inadequate disclosure. Information asymmetry arises where disclosure by itself is insufficient to resolve the market failure. Information asymmetry arises in situations where buyers and sellers of particular products or services will never be equally-well informed - regardless of how much information is disclosed. Regulation to deal with information asymmetry is usually referred to as "prudential regulation".

At issue in prudential regulation is the complexity of both the product and the institution offering it. This problem is common in areas such as drugs and aviation and is particularly relevant in the area of financial services. The regulatory response in these cases is to interpose a regulatory body between the supplier of the service and the consumer. The role of the regulator is to establish and enforce a set of behavioural rules for the supplier that are designed to ensure that the promises being made by the supplier have an acceptably high probability of being met. Since no regulator can guarantee that all promises will be met under all circumstances (to do so would require extreme, self-defeating regulation) it is common for governments to add an additional level of government support, such as deposit insurance, in those cases where these particular promises are not met.

The range of financial institutions and activities that should be covered by prudential regulation is a matter of judgement. Typically, deposit taking and insurance are subjected to prudential regulation. In some countries, the prudential net is extended to include private pension schemes, securities dealers, and other financial institutions. The crisis of 2008 has caused some to question whether the range of institutions subject to prudential regulation has been too narrow.

Prudential regulation overcomes the asymmetric information market failure in part by substituting the judgement of a regulator for that of the regulated financial institutions and their customers. To the extent that the regulator absorbs risks which would otherwise be born by financial institutions and their customers it introduces a 'moral hazard' problem - whereby the perceived shifting of risk from the regulated financial institutions to the regulator may induce the institutions to take greater risks than they would otherwise take. Moral hazard is accentuated when explicit government guarantees are involved.

The incentive problems associated with moral hazard explain the particular approaches that prudential regulators normally adopt to the various aspects of prudential regulation. It also means that the potential cost of prudential regulation in terms of economic efficiency can be very high if the conflicting incentives are not handled very carefully. Consequently, there is an onus on governments both to limit the spread of the prudential umbrella to those parts of the financial system that genuinely warrant this form of regulation and to ensure that the regulator adopts regulatory measures that correct the market failure at minimal cost.

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The primary distinction between the methods used by prudential regulators and those used by competition and conduct regulators is that the former are largely preventative (i.e., they primarily seek to avoid promises being broken), while the latter are largely responsive (that is, they primarily involve prosecution of those who break their promises or who disobey the rules). Prudential, or preventative, regulation involves the imposition of prescriptive rules or standards governing the prudential behaviour of financial institutions making certain types of promises. These rules may be directed at specific areas of concern, or directed more generally towards ensuring that these institutions have the financial strength and soundness to honour the promises that they have made.

The fourth main source of financial market failure is systemic instability. It is a fundamental characteristic of parts of the financial system that they operate efficiently only to the extent that market participants have confidence in their ability to perform the roles for which they were designed. Systemic instability arises where failure of one institution to honour its promises leads to a general panic as individuals and corporations fear that similar promises made by other institutions may also be dishonoured. A crisis occurs when contagion of this type leads to the distress or failure of otherwise sound institutions. The liquidity crisis of September 2008, following the failure of Lehman Brothers is one of the most vivid examples of this type of systemic instability.

The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system to deliver against its promises. The importance of finance and the potential for financial failure to lead to economic ins tability introduces an 'overarching externality' that warrants regulatory attention.

The primary defence against systemic instability is the maintenance of a sustainable macroeconomic environment, with reasonable price stability in both product and asset markets. This responsibility falls directly to government in its formulation of monetary and fiscal policy. Systemic stability is also supported by having a prudentially sound system of financial institutions. Thus, policies designed to combat market failure arising from asymmetric information automatically support policies designed to combat market failure arising from systemic instability. As highlighted by the crisis of 2008, policies designed to reduce the opacity of financial markets and to provide regulators with adequate information on systemic inter-linkages and aggregate systemic exposures can be just as critical.

Beyond these general macroeconomic and prudential measures, the additional regulatory tools most appropriate for resolving this type of market failure are the lender of last resort facility and direct regulation of the payments system.

The Committee recommended a regulatory structure comprising four separate agencies, each of which would be assigned the objective of addressing one the four main sources of market failure. In July 1998, based on the Committee's recommendations, the Government instituted what has come to be known as an "objectives-based" regulatory architecture based on the following four agencies:

- the Australian Competition and Consumer Commission (ACCC), which is responsible for competition regulation and consumer protection throughout the whole economy;
- the Australia Securities and Investments Commission (ASIC), which is responsible for conduct regulation across the financial system, including all financial institutions, markets, and market participants;

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- the Australian Prudential Regulation Authority (APRA), which has responsibility for the prudential soundness of all deposit taking, general and life insurance, and private pension schemes; and

- the Reserve Bank of Australia (RBA), which is responsible for systemic stability, through monetary policy, provision of system liquidity, and regulation of the payments system.

This architecture has also been referred to as a "twin peaks" architecture, a term coined by Michael Taylor to describe a structure in which conduct and prudential regulation are each carried out by a separate regulator. In this terminology, the Australian model is more accurately described as a "four peaks" model. While unique at the time, this model, or a variant of it, has since been implemented by the Netherlands.

The Committee considered a wide range of issues in arriving at its recommendations. Among the more difficult of these were: whether or not to separate banking regulation from monetary policy; where to draw the boundaries around those institutions warranting prudential regulation; and how best to ensure inter-agency cooperation.

The Committee recognised that there were significant synergies between banking regulation and monetary policy. Coupled with the credibility enjoyed by the RBA as a successful banking regulator, there was a strong case to retain banking regulation within the RBA. There was, however, an equally powerful argument that the growth of financial conglomerates required a more coherent approach to prudential regulation than could be provided by different agencies. While the Committee considered adding regulation of insurance and other deposit-takers to the responsibilities of the RBA, there would have been a danger that pursuing two very different and potentially conflicting objectives might distract the RBA from its primary responsibilities of monetary policy and system stability. Ultimately the Committee decided that a new agency dedicated to all forms of prudential regulation and a streamlined central bank responsible for systemic stability through its control of monetary policy and the payments system offered a more focused and flexible structure.

Drawing the boundaries around prudential regulation was also difficult. Ultimately, the Committee decided that the boundaries should be determined by the nature of the particular financial promises being made by particular types of financial institutions.

Not all financial promises are equally intense. Financial promises can be distinguished according to three primary characteristics:

- the inherent difficulty of honouring the promise;

- the difficulty faced by the consumer in assessing the capacity of the promissor to deliver on the promise; and

- the extent of adversity that would be caused by promissory breach.

Each of these characteristics involves risk. The more difficult the promise is to keep, the greater the risk to the consumer and the greater the impact of information asymmetry. Some financial promises, such as common equity claims, are relatively easy to honour in that they contain very general and flexible obligations. Other financial promises, such as demand deposits (a promise to pay a fixed nominal amount at the total discretion of the promisee) are very onerous.

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The more complex the institution making the promise, the more difficult it is for the promisee to assess its capacity to deliver on its promises, and therefore the greater the risk for the promisee. Some structures, such as simple trusts, are relatively transparent, while others, such as banks and insurance companies (especially when they are part of financial conglomerates) can be extremely complex and opaque.

Finally, the greater the consequences of promissory failure, the greater the risk, not only to the individual, but also to the community. The consequences of the failure of a major insurance company to honour its insurance claims, for example, would be likely to generate much greater adversity within the community than the failure of a non-finance company to meet its equity obligations.

Since prudential regulation is costly and interventionist by nature, the Committee believed that it was important that it be limited to institutions making financial promises that were judged to have a sufficiently high intensity in all three characteristics outlined above. Only in these cases would the potential cost of the market failure dominate the potential efficiency costs of prudential regulation.

While the case for including all deposit-taking institutions and all forms of insurance within the prudential net was very strong, the case for pensions was less so. The situation was complicated by the way in which the Australian pension system had evolved since the mid 1980s. To reduce the burden on a growing unfunded public pension scheme, successive Australian Governments had encouraged private pension provision through tax concessions and a series of compulsory pension contributions imposed on employers as an offset to wage claims. The vast majority of the funds that emerged in response to this policy were defined contribution schemes in which the investment risks are borne ultimately by the pension beneficiary. Thus, these funds ranked low on the first promissory characteristic, although higher on the second, and very high on the third. While this made a case to treat pensions like any other forms of investment, there was still a significant defined benefit pension industry, pension contributions were mandatory, and the choice of fund was restricted. In combination, these meant that the Government retained at least an implicit responsibility associated with the risk of fraud and poor management. For these reasons the Committee recommended including private pensions within the prudential responsibility of APRA.

Finally, to encourage inter-agency cooperation, the Committee recommended establishing the new prudential agency, APRA, with a Board that would include ex-officio representatives from ASIC and the RBA. When APRA was restructured in 2003 as a Commission, and the inter-agency representation was lost, responsibility for coordination passed to the Council of Financial Regulators, which includes representatives of the RBA, APRA, ASIC, and the Commonwealth Treasury.

The assumed strengths of the objectives-based architecture are many. In general these have been born out by the Australian experience.

First, by assigning each regulatory agency to a single objective, there is maximum regulatory focus. This model avoids the conflict of objectives faced by regulators under virtually every other architecture. Where an agency faces multiple objectives there is a danger is that one will, for whatever reason, dominate the other in terms of visibility with senior management and/or allocation of resources (as appears to have been the case with Northern Rock in the UK).

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Second, there are significant potential synergies in bringing together all regulators of a particular market failure. APRA, for example, was able to bring together best practices from banking and insurance regulation to create a stronger framework for both. APRA was also one of the first agencies to apply a broad risk-based supervisory approach to all prudentially-regulated sectors of the financial system. Similarly, by bringing all markets under ASIC's purview Australia was one of the first countries in the world to introduce a single licensing regime for market participants.

Third, bringing all prudentially-regulated entities under the one roof is conducive to eliminating regulatory arbitrage. Prior to the creation of APRA there were at least three different types of institution able to issue demand deposits in Australia. These were regulated by nine different agencies. Following its creation, APRA introduced a fully-harmonized regime for all deposit-taking institutions. These are now regulated as "Authorized Deposit-taking Institutions" (ADIs) under a single licensing regime. This coherence over deposit taking was important in preventing a shadow banking sector from emerging in Australia.

Fourth, bringing all prudentially-regulated institutions under the one roof should facilitate a more consistent and effective approach to regulating financial conglomerates. APRA has been at the forefront of international efforts to develop a framework for consolidated supervision of conglomerates.

Fifth, allocating a single objective to each regulator minimizes the overlap between agencies and the inevitable turf wars that accompany such overlaps. There are always grey areas in practice, however neat the principles might appear in theory. The greatest potential overlaps are between prudential regulation and systemic stability regulation on the one hand (to the extent that prudential soundness provides one of the key foundation stones for systemic stability), and between prudential and conduct regulation on the other (to the extent that they each involve regulation of different aspects of the same institutions). Notwithstanding the potential for overlap, these have tended to diminish rather than amplify with time and experience. In part this is a consequence of the clear lines of responsibility in each situation. And, in part, it is a consequence of the determination by the key parties to cooperate in the interests of the system as a whole.

Sixth, the allocation of a single objective to each agency should minimize cultural clashes. As a general rule, conduct agencies are dominated by lawyers. Prudential agencies, in contrast, are typically dominated by accountants, economists, and finance experts. When these two groups are combined in the same agency there can be a clash of cultures as one seeks to dominate the other.

Finally, in line with the expectations of the Wallis Committee, streamlining the old (partly State-based) regulatory structure reduced the cost of regulation and facilitated strong financial sector development and new entrants to the field, without reducing safety or soundness.

Notwithstanding the resilience of the Australian financial system over the past 18 months, we have learned much about our architecture and our overall approach to financial regulation from the international crisis. Regulators worldwide have much about which to be modest, and Australian regulators are no exception.

On the positive side, the objectives-based architecture withstood its first major test without collapsing. Indeed, the Australian financial system has weathered the financial storm better than most, although we have certainly not been immune from the economic consequences that have followed. The resilience of the Australian system was helped by exceptionally tough prudential standards. Whereas some countries exploited "discretions" in the Basel framework to lower the capital requirements for their local banks, APRA went the opposite direction to impose arguably

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the toughest regime in the world. As a consequence, our major banks are among the few AA rated banks left standing. Our resilience was also helped by some good fortune. As pointed out by our recently retired RBA Governor, Ian Macfarlane, the reliance of Australian banks on global wholesale markets for funding left the system with a liquidity risk, but helped it avoid some of the credit risks taken by banks in other countries that had surplus deposits and a shortage of suitable local lending opportunities.

In terms of crisis management the coordination arrangements worked as expected, with excellent cooperation between agencies on information flows and rapid responses to the exigencies of the times. The singularity of focus provided by the objectives-based architecture was seen by the Australian agencies as a major positive factor in this respect.

On the less positive side, we have learned that both the regulators and industry know less about measuring and managing risk than we thought we did. The regulatory focus on value-at-risk has proved to be misplaced. Risk measures based on historical data that focus on the centre of the distribution of outcomes are poorly placed to deal with tail-risk events. In its defence, APRA has been among the few international regulators to conduct extensive stress (or scenario) tests of the industry over the past decade, although the sophistication and regularity of these will undoubtedly increase in coming years. We have seen at first-hand the dramatic pro-cyclical impact of market-value based accounting and regulatory rules. We have had to rethink the way in which liquidity risk is measured and regulated.

Most importantly, we have learned that financial stability regulation is a much more complex exercise than simply overseeing the payments system and keeping the monetary policy dials on autopilot. The need for much greater information about inter-linkages and exposures throughout the financial system is obvious. Less obvious is how to collect and ensure the security of that information, given the commercial sensitivity of much of what will be involved.

It is difficult to predict the exact shape of financial regulation in five years. What is reasonably certain is that the standards, methods, and approaches applied will look quite different to those that have been that were applied over the past five years. If not, we will be destined to experience the same problems.

But these are challenges more for regulatory implementation rather than regulatory architecture.

Jeffrey Carmichael

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Testimony of W Edmund Clark
Senate Committee on Homeland Security and Governmental Affairs,
Where Were the Watchdogs? Financial Regulatory Lessons from Abroad

May 21, 2009

Mr. Chairman and Other Members of the Senate Committee:

I am Ed Clark, President and CEO of TD Bank Financial Group. Thank you for this opportunity to testify before this Senate Committee.

I have been asked to provide comments on the Canadian Banking experience. I should state up front though that I do not think it is my role to opine on how the U.S. banking system should be set up moving forward. What I can do is tell you how Canadian Banks have operated. Let me start, however, with a few words about TD.

TD is a North American bank that offers a full range of financial products and services to our 17 million customers worldwide of which 6.5 million banking customers are in the U.S. We have four key businesses: Canadian Personal & Commercial Banking, Wealth Management, U.S. Personal & Commercial Banking and Wholesale Banking. Currently we have 1,009 bank branches in the U.S. and 1,107 branches in Canada. We also own 45% of TD Ameritrade which has over 6 million customers and is the world's largest online broker as measured by trades per day.

At the end of our first quarter of 2009 we had $477 billion (USD) in assets and $328B (USD) in deposits. We employ more than 65,000 full time employees including more than 23,000 in the U.S. We have a strong capital base with our Tier 1 ratio above 10% of

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which more than 75% is tangible common equity. We are one of only three banks listed on the NYSE that are rated Aaa by Moody's. Our market capitalization is $35.9B USD which makes us the 5th largest bank in North America.

Our retail model in both Canada and the U.S. is built upon our unique service and convenience proposition to our customers. In both the US and Canada, our branches are open on average 50% longer than our competitors. In both markets, J.D. Power and Associates has repeatedly recognized TD's outstanding customer service. In fact, just this week TD Bank, America's Most Convenient Bank, ranked highest in customer satisfaction in the Mid-Atlantic region according to the J.D. Power and Associates 2009 Retail Banking Customer Satisfaction Study[SM]. We have earned this recognition for the fourth year in a row.

We largely avoided the major issues that damaged banks around the world in the financial crisis. With respect to our wholesale business we made the strategic decision to exit the structured products area in 2005 as we were not comfortable with the associated risks. In the U.S. we avoided lending in the way that got many U.S. banks in trouble. Specifically, we did not do subprime lending nor did we lend significantly out of our footprint. We also lent using our own people and distribution system, not third party commissioned sales people.

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The fact that we were able to stay profitable through this crisis has meant that we have been able to grow – adding almost 50 branches on a North American basis last year and we continue to lend. Our U.S. lending is up QoQ, 17% on an annualized basis.

Let me now turn to what has made Canada different throughout this global crisis. The Canadian banking system has weathered the financial crisis better than most. Our banks are profitable. They have been able to manage through this crisis without any kind of bailout from the Canadian taxpayer. No single answer explains this performance; rather it is a combination of factors. Sound management has a lot to do with any banks' success. But Canadian banks' strength is also the result of good public and monetary policy, a strong regulatory environment, and a large Canadian investor base that was willing to back the banks throughout this period. From the very beginning the Bank of Canada, OSFI (Office of the Superintendent of Financial Institutions) and Canadian bank CEOs have worked closely together – pro-actively trying to get in front of upcoming challenges. A core difference in Canada compared to other countries was the reliance on the private sector to provide equity to reinforce our banking system. The willingness of the Canadian banks to price that equity attractively, to raise the desired capital, and the confidence of the Canadian investment community in the soundness of our institutions was a critical factor.

There were other, longer term structural advantages in our system.

- The structure of the Canadian banks is such that the large dealers are owned by the major banks. Therefore we did not have a Bear Stearns or Lehman equivalent.

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This does not mean that we have avoided dealer losses; the Canadian banks have written down about $18 billion (CAD) since the crisis began (although TD has had almost no write-downs). What the Canadian structure does mean, however, is that the retail earnings power of the Canadian banks has allowed them to shoulder the dealer losses incurred.

- In Canada the mortgage market is fundamentally different than the one in the U.S. First, in Canada we cannot write a mortgage loan for more than 80% loan to value unless it is insured. Second, our mortgages are underwritten to hold which means Canadian banks have "skin in the game". Third, the mortgage market was heavily concentrated in the banks and they opposed sub-prime mortgages because they would bear the risks though a small market did develop outside of the banks. As a result, the development of more exotic type mortgage instruments such as no-document loans or Option Arms were either very limited or never created in Canada. In addition, mortgage interest is not tax deductible in Canada so our customers are less inclined to leverage up.

- The Canadian mortgage system also enabled us to solve the liquidity problems that surfaced world-wide during the crisis. Given that many of our mortgages were government guaranteed we were able to sell them back to the Canadian government without the government taking any additional risk. Indeed the government made substantial profits on the sales while providing the banks with needed liquidity and avoiding any government guarantee of our debt issuance.

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- From a regulatory perspective we are governed by capital tests that look at both the total assets and risk weighted assets. In general, the risk weighted test is the binding restraint. Because of this we are not incented to sell low risk assets. There is a legitimate concern that an absence of tough total asset leverage ratios has allowed wholesale banks to become excessively leveraged. In developing these tests it is worthwhile recognizing that a total leverage test, applied as the binding restraint, to a typical personal and commercial bank may result in such a bank being precluded from running a lower risk retail model like ours.

- Speaking specifically about Canadian regulators, we have a single regulator for all the major banks – OSFI – Office of the Superintendent of Financial Institutions. It has focused:

    - First, on capital and in particular the quality of capital. Before the crisis, to be considered well capitalized required a Tier 1 ratio of 7% of which 70% had to be common equity. In response to the crisis, particularly the need to ensure Canadian banks could easily raise the capital needed to keep lending, and to ensure that Canadian banks had more comparable leverage ratios to the more leveraged capital structures of non-Canadian banks, OSFI moved from a 70% to 60% common equity requirement. This provided the additional flexibility required to level the playing field. And while OSFI had set a target of a 7% Tier 1 ratio, they also encouraged

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the Canadian banks to have robust internal capital adequacy processes, which in turn played a role in banks having Tier 1 ratios much higher than 7% - closer to 9% or 10% in fact.

- Second, the regulator has taken a less detailed and more principle based approach to risk. Specifically, they want to know that we understand the risks we are taking and fully appreciate that ultimately, we own the risks associated with our decisions. They want to understand our risk management processes and they focus on the role of our Board – and its knowledge of the risk choices we have made. Regulators can obviously lean against banks and their actions but it is the people at the top that must be accountable for the system to function successfully in the long term.

- There has been a lot of talk about compensation and the role of compensation management practices in the crisis. Canadian Banks moved to adopt some time ago, in response to investor suggestions, changes consistent with what are now considered best practises. At TD our compensation programs are designed to align with shareholder outcomes. In fact, executives experience more downside than shareholders in tougher economic times. This alignment is achieved by providing a significant portion of compensation for our most senior executives in long term equity; having the highest share ownership requirements relative to our peer group; requiring share ownership to extend post termination or retirement; reducing the use of stock options over time and limiting the leverage in our compensation plans. This approach to compensation is utilized for all executives

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at TD, including the most senior executives of our wholesale and personal and commercial businesses. In addition, the pay for all executives at TD is impacted by the financial performance of the bank overall and not just their individual businesses and most importantly by the results of our ongoing measure of customer experience.

- The Canadian banks corporate governance is such that they all have separate CEOs and Chairs. These distinct roles, held by two qualified leaders, ensure that the interests of the shareholders, customers and employees are balanced. The Directors of the Board regularly meet at Board and Committee meetings without the CEO or management present.

Conclusion

I said at the start of my remarks on the Canadian banking system that the simple fact is that there is no magic bullet – no single answer – but rather it is a combination of factors as to why the Canadian banks have come out of this crisis better positioned than most of their global peers. I also think we have to be very careful about exaggerating the "unique" success of Canada. As it happens we did very well through this crisis but I would not want to assume that will always be the case nor do I think we can rest on our laurels.

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I believe that at the heart of well run financial institutions and ultimately financial systems are leaders that run their institution in a way that it can withstand significant shocks. I think I speak for all the Canadian bank CEOs when I say we understand that we must take care of our shareholders and the institution for the long haul. We feel an obligation, the same as many U.S. bank CEOs do, to leave the institution in better shape than when we started so that it survives for generations to come. We all appreciate that our institutions are vital to the economies where we operate – in our case predominantly Canada and the U.S. And as a result we manage them in a way that doesn't put them at risk for potentially lucrative short term plays. This thinking is reinforced by our regulator and as I said earlier our compensation aligns to this way of thinking. And the stability of our earnings and nature of our capital regime allows us to withstand the shocks I talked about earlier.

In conclusion, I think it is also important to appreciate that it is unlikely that a regulatory system on its own can solve all the problems. A mix of sound regulation and sound business practices from the financial institutions is required. But having only the former without the latter would lead inevitably to a regulatory structure that would be detrimental to the marketplace. For Canada, it has been a combination of the commitment of Canadian bank CEOs, the relationship between the regulator, government and Canadian banks and the support of the equity market that has enabled the Canadian banks to weather this storm successfully.

Thank you again for this opportunity to testify before this Senate Committee. Please feel free to ask any questions you might have.

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Testimony of

David G. Nason

Managing Director, Promontory Financial Group, LLC

Before the Senate Committee on Homeland Security & Governmental Affairs

May 21, 2009

Chairman Lieberman, Ranking Member Collins and Members of the Committee, thank you for inviting me to appear before you today on financial services regulatory matters. These are important and timely issues to discuss, especially from the global perspective. As the United States begins to evaluate its financial regulatory framework, it is vital that it incorporate lessons and experience from other countries' reform efforts.

I currently serve as a Managing Director of the Promontory Financial Group, LLC, a global financial services consulting firm founded by Eugene Ludwig, a former Comptroller of Currency in the Clinton Administration. I am particularly pleased to be joined here by Mr. Jeffrey Carmichael, who is also part of the Promontory firm, and leads Promontory's Australasia office, based in Singapore. I recently finished a three-year stint at the U.S. Department of Treasury where I was honored to serve both Secretaries Snow and Paulson. As the Assistant Secretary of Treasury for financial institutions, I advised former Secretary Paulson on Treasury's responses to the current financial crisis, including many aspects of the Troubled Asset Relief Program ("TARP") and related financial stability efforts. In addition, I am particularly proud to have led the team that researched and wrote Treasury's "*Blueprint for a Modernized Financial Regulatory Structure*" ("Blueprint") which was published in March 2008. Many of the issues that we evaluated in the writing of the Blueprint are before the Congress and the focus of this hearing.

I. Introduction

Financial institutions play an essential role in the U.S. economy by providing consumers and businesses a means to save for the future, to protect and hedge against risks, and to access funding for consumption or organize capital for new investment opportunities. A number of different types of financial institutions provide financial services in the United States: commercial banks and other insured depository institutions, insurers, companies engaged in securities and futures transactions, finance companies, and specialized companies established by the government. Together, these institutions and the markets in which they act underpin economic activity through the intermediation of funds between providers and users of capital.

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This intermediation function is accomplished in a number of ways. Overall, financial institutions serve a vitally important function in the U.S. economy by allowing capital to seek out its most productive uses in an efficient matter. Given the economic significance of the U.S. financial services sector, it is important that we examine the structure of our regulatory framework. This is all the more pressing as the United States begins to emerge from the current financial crisis.

Even before this financial crisis, however, many had recognized that the capital markets and the financial services industry have evolved significantly over the past decade. These developments, while providing benefits to both domestic and global economic growth, have also exposed the financial markets to new challenges. Globalization of the capital markets is a significant development. Foreign economies are maturing into market-based economies, contributing to global economic growth and stability and providing a deep and liquid source of capital outside the United States. There is an emerging consensus that a regulatory framework that combines flexibility and prudence is best suited to respond to financial markets' dynamism and complexity.

The root causes of the current financial markets stress are well documented. Following many years of benign economic conditions and plentiful market liquidity, global investors had become complacent about risks, even in the case of new and increasingly complex financial instruments. There was a dramatic weakening of underwriting standards for U.S. mortgages, especially subprime mortgages, beginning in late 2004 and extending into early 2007. The loosening of credit terms in the subprime market was symptomatic of a much broader erosion of market discipline on the standards and terms of loans to households and businesses.

The confluence of many events led to a significant credit contraction and a dramatic repricing of risk. Sentiment swung hard to risk aversion and there was an erosion of confidence in financial firms across the globe. We are still living through this process right now and we have seen more government intervention in the financial markets than we have seen in decades.

The focus of this hearing today is prospective, however. How can we in the United States do better and what can we learn from our colleagues around the world? The financial crisis has taught us that regulatory structure is not merely an academic issue and that topics like regulatory arbitrage matter and have meaningful repercussions outside of the province of academia. Indeed, if we look for something positive in the aftermath of this crisis it might be that it will give us the courage to make the hard choices and reform our financial regulatory architecture.

We have learned that our regulators and regulations were not well positioned to adapt to the rapid financial innovation driven by rapid capital mobility, deep liquidity, and technology. These conditions led to three major financial developments that were contributors to the crisis: the rapid proliferation of structured financial instruments, the growth of credit markets outside of the traditional regulated framework, and false confidence in internal and external risk management practices and credit ratings agencies. Financial institutions and regulators alike touted the benefits of these innovations as tools to diffuse risk throughout the financial system.

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Unfortunately, many did not recognize that the growth of the financial institutions' cross-market activities and integration with the broader economy ensured that turmoil in one part of the financial markets would spread to others, and ultimately to the real economy.

Regulation alone and modernized regulatory architecture could not have prevented all of the problems from these developments. However, a more robust regulatory framework with oversight responsibility for cross-market activities and a focus on systemic risk could have recognized their collective dangers and could have potentially acted preemptively to limit their impact.

II. Brief Discussion of the Current US Regulatory Structure:

Our current regulatory structure no longer reflects the complexity and dynamic nature of today's financial markets.

The current U.S. regulatory framework for financial institutions is based on a structure that developed over many decades. Uniquely among nations, we have a dual banking system that is deeply rooted in our national character and reflects the distaste for centralized economic authority that characterized the earliest years of our republic. The regulatory basis for depository institutions evolved gradually in response to a series of financial crises and other important social, economic, and political events: Congress established the national bank charter in 1863 during the Civil War, the Federal Reserve System in 1913 in response to various episodes of financial instability, and the federal deposit insurance system and specialized insured depository charters (e.g., thrifts and credit unions) during the Great Depression. Changes were made to the regulatory system for insured depository institutions in the intervening years in response to other financial crises (e.g., the thrift crises of the 1980s) or as enhancements (e.g., the Gramm-Leach-Bliley Act of 1999, or "GLB Act"); but, for the most part the underlying structure resembles what existed in the 1930s.

Similarly, the bifurcation between securities and futures regulation was largely established over seventy years ago when the two industries were clearly distinct. In addition to the federal role for financial institution regulation, the tradition of federalism preserved a role for state authorities in certain markets. This is especially true in the insurance market, which states have regulated with limited federal involvement for over 135 years. However, state authority over depository institutions and securities companies has diminished over the years. In some cases there is a cooperative arrangement between federal and state officials, while in other cases tensions remain as to the level of state authority. In contrast, futures are regulated solely at the federal level.

Historically, the regulatory structure for financial institutions has served the United States well. However, the complexity intrinsic to our evolving financial markets and the growing institutionalization of the capital markets and the severity of the current financial crisis is pressuring the U.S. regulatory structure, exposing regulatory gaps as well as redundancies. The U.S. regulatory structure reflects a system, much of it created over seventy years ago, grappling

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to keep pace with market evolutions and, facing increasing difficulties, at times, in preventing and anticipating financial crises.

Largely incompatible with these developments is the current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities, and futures. A functional approach to regulation exhibits several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. In addition, the inability of any regulator to take coordinated action throughout the financial system makes it more difficult to address problems related to financial market stability.

Moreover, our system also results in duplication of certain common activities across regulators. While some degree of specialization might be important for the regulation of financial institutions, many aspects of financial regulation and consumer protection regulation have common themes. For example, although key measures of financial health have different terminology in banking and insurance—capital and surplus respectively—they both serve a similar function of ensuring the financial strength and ability of financial institutions to meet their obligations. Similarly, while there are specific differences across institutions, the goal of most consumer protection regulation is to ensure consumers receive adequate information regarding the terms of financial transactions and industry complies with appropriate sales practices. American regulatory inefficiencies, which were once primarily concerns for the competitiveness of the US financial sector, have revealed themselves as major threat to the stability of the US and global economy. We must seize the present opportunity to realize both the objectives.

III. Comparison of Regulatory Models Around the World

As we consider the future construct of our financial regulation, we should first look to the experience of others countries, especially those that have conducted a thoughtful review recently. As global financial markets integrate and accounting standards converge, it is only natural for regulatory practices to follow suit. There are two dominant forms of financial regulatory regimes that should be considered seriously, the consolidated regulator approach and the "Twin Peaks" approach.

Under a single consolidated regulator approach, one regulator responsible for both financial and consumer protection regulation would regulate all financial institutions. The United Kingdom's consolidation of regulation within the Financial Services Authority exemplifies this approach, although other countries such as Japan have also moved in this direction. The general consolidated regulator approach eliminates the role of the central bank from financial institution regulation, but preserves its role of determining monetary policy and performing some functions related to overall financial market stability.

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A key advantage of the consolidated regulator approach is enhanced efficiency from combining common functions undertaken by individual regulators into one entity. A consolidated regulator approach should allow for a better understanding of overall risks to the financial system as one entity would regulate all financial institutions. This last benefit increases in importance as the size and significance of diversified financial conglomerates rises. Finally, a consolidated regulator approach avoids issues associated with overlapping jurisdictions of individual regulators.

While the consolidated regulator approach can deliver a number of benefits, several potential problems also arise. First, housing all regulatory functions related to financial and consumer regulation in one entity may lead to varying degrees of focus on these key functions. Second, a consolidated regulator approach to financial oversight might also lead to less market discipline as the same regulator would regulate all financial institutions, whether or not they have explicit government guarantees. This would seem to be particularly important in the United States where a number of financial institutions have access to explicit government guarantees of varying degrees. Third, since regulatory reform must consider the role of the central bank, the consolidated regulatory approach must maintain some degree of close coordination with the central bank if the central bank is going to be ultimately responsible for some aspect of market stability. This is especially important as the Turner Report, which analyzes and reviews the U.K. regulatory system, requires a shifting of focus to systemically important banks, validation of risk models, more information disclosure on key risks, and the establishment of a resolution authority for large financial institutions.

Finally, the scale of operations necessary to establish a single consolidated regulator in the United States could make the model more difficult to implement in comparison to other jurisdictions.

Another approach, adopted mostly notably by Australia and the Netherlands, is the "Twin Peaks" model that emphasizes regulation by objectives. One regulatory body is responsible for prudential regulation of relevant financial institutions and a separate and distinct agency is responsible for business conduct and consumer protection. The primary advantage of this model is that it maximizes regulatory focus by concentrating responsibility for correcting a single form of market failure — one agency, one objective. This consolidation reduces regulatory gaps, turf wars among regulators and the opportunities for regulatory arbitrage by financial institutions, while unlocking natural synergies among regulatory agencies. Perhaps most importantly, it reflects the financial markets' extraordinary integration and complexity. This structure does pose a key problem in that that effective lines of communication between the "peaks" is vital to success. Effective communication among regulators is important for coordinating examinations and other activities impacting the operations of financial institutions.

IV. Idea and Proposals Under Consideration:

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While there are several ideas and proposals for the reform of the financial regulatory system in circulation, I would like to focus on three ideas that were described in the Treasury's March 2008 Blueprint, Secretary Geithner's Testimony to the House Financial Services Committee on March 26, 2009, and FDIC Chairman Bair's testimony to the Senate Committee on Banking, Housing & Urban Affairs on May 6, 2009. Each of these proposals calls for the establishment of systemic risk regulation.

The March 2008 Blueprint proposes that the US adopt an objectives-based regulatory framework with three objectives: market stability regulation, prudential financial regulation to address issues of limited market discipline and business conduct regulation. Prudential financial regulation housed within one regulatory body can focus on the common elements of risk management across financial institutions, as the current crisis revealed the devastating impact of their cross-market exposure. Regulators focused on specific objectives can be more effective at enforcing market discipline by their targeting of financial institutions for which prudential regulation is most appropriate.

The Blueprint lays out an optimal structure consisting of three distinct regulators focused exclusively on financial institutions: a market stability regulator, a prudential financial regulator and a business conduct regulator.

In his testimony to the House Financial Services Committee, Secretary Geithner called for the creation of single regulatory entity with responsibility for systemically important institutions, critical payment and settlement activities. This regulator should impose capital, liquidity, counterparty and credit risk management requirements that are more stringent than other, smaller financial institutions. Secretary Geithner emphasized that these requirements must be designed to dampen, rather than amplify financial cycles. Similar to the Turner Report for the UK, Secretary Geithner recommended that a stronger resolution mechanism for large complex financial institutions, under permanent authority, be a cornerstone of future financial regulation.

FDIC Chairman Sheila Bair addressed the regulatory challenges for financial institutions deemed to "too big to fail" in her recent testimony to the Senate. The failure of one of these institutions poses a significant danger to the economy while their complexity limits effective supervision. The challenge therefore is to create a fail-safe system where if one institution fails, the system can avoid a near domino-like collapse of other financial institutions. Chairman Bair proposed the two consistently mentioned approaches to reduce this likelihood: first, devise a supervisory framework to regulate systemic risk; second, establish comprehensive resolution authority for systemically important financial institutions to make their failure credible and feasible.

V. Conclusions

While there is an emerging consensus among global financial regulators, market participants, and policy makers that systemic risk regulation and resolution authority must be a cornerstone of reformed financial regulation, the exact details of proposals need to be settled. These are very complicated issues that require thoughtful debate and deliberation.

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One point, however, is clear — the United States' regulatory system, in its current form, is incapable of guarding against the risks that brought our financial markets and our economy to the brink of collapse. As we expand our financial regulatory authorities and power, we should guard against natural tendencies of associating "more" regulation with "good" regulation. Innovation, evolution and profitability are critical to retaining the global leadership of the American financial sector. To this end, the future American regulatory framework must be directed toward its proper objectives — to maintain a stable, well-capitalized and responsible financial sector that will supply the credit and allocate capital efficiently to grow our real economy.

Thank you for inviting me here today.

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Post-Hearing Question and Answer for the Record
"Where Were the Watchdogs?
The Financial Crisis and the Breakdown of Financial Governance"
January 21, 2009

Prepared by Gene L. Dodaro, Acting Comptroller General of the United States, for Senator Susan M. Collins, Ranking Member, Committee on Homeland Security and Governmental Affairs, United State Senate

Question

1. In 2002, Warren Buffet wrote to his Berkshire Hathaway Shareholders that at Berkshire Hathaway:

   "We try to be alert to any sort of mega-catastrophe risk, and that posture may make us unduly appreciative about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

   Certainly, Mr. Buffet's warning in 2002 seems to have come true in 2008. In particular, AIG, a global conglomerate, imploded this past year when the derivative activity within one of its subsidiary consisted of latent and lethal risks that AIG should not have taken. At the same time, even if derivatives pose this potential for sudden and devastating collapse of a company, I don't believe we can simply outlaw them. Derivatives are one method for companies to hedge their exposure to risk by finding a willing counterparty to share that risk. We need greater visibility of all derivative activity and this would allow regulators to see when one company's derivative activity is in danger of affecting many other counterparties. How do we achieve this goal?

Answer

Over-the-counter (OTC) derivatives have proven to be a useful tool for financial market participants to manage risks, obtain returns, or achieve other objectives. However, like any financial activity, OTC derivatives can produce risks to their users, providers, and potentially to the system as a whole if not carefully managed. As a result, creating greater visibility of these derivatives activities so that regulators can identify how the activities of one firm could potentially affect other market participants would be a useful result of the needed reforms to the financial regulatory system we advocated in our recent report.[1] Identifying increased transparency and reduced systemic risk as regulatory goals are part of an important first step to achieving urgent reforms to an outdated regulatory system that has been outpaced by market developments.

[1] GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

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In our report, we expressed concerns about risks associated with OTC derivatives. These products are largely unregulated by U.S. financial institution regulators. As you have noted, the large size of the market and relative concentration of these products among dealers means that the failure of one of these major dealers could produce counterparty credit losses that could harm other important institutions. The notional or face value of outstanding credit default swaps (CDS), which are a relatively newer type of OTC derivative, has increased almost tenfold from just over $6 trillion in 2004 to almost $58 trillion at the end of 2007, according to the Bank for International Settlements. As CDS are not considered to be securities or futures, no regulator oversees these products, although the dealers that offer them are regulated by either securities or banking regulators.

One way to achieve the goal of greater transparency of these products and their risks would be through the creation of a systemic risk regulator that is provided with the authority to collect more information on derivatives activities by financial institutions and to take steps to address dangers posed to other institutions and the system as needed. As we note in our report, having a single entity responsible for assessing threats to the overall financial system could prevent some of the crises that we have seen in the past. In its *Blueprint for a Modernized Financial Regulatory Structure*, Treasury proposed expanding the responsibilities of the Federal Reserve to create a "market stability regulator" that would have broad authority to gather and disclose appropriate information, collaborate with other regulators on rulemaking, and take corrective action as necessary in the interest of overall financial market stability. Such a regulator could assess the systemic risks that arise at financial institutions, within specific financial sectors, across the nation, and globally.

Overseeing derivatives activities could be a key component of this new regulatory responsibility. Regulators would need to identify the most important information needed to identify risks associated with derivatives activities. For example, all financial institutions, including less-regulated entities like hedge funds, could be required to report positions to a regulator similar to large trader reporting requirements of the Commodity Futures Trading Commission (CFTC).[2] They might also consider what enhancements to examination activities might be appropriate to provide a systemic risk or other regulator with the ability to gather any needed information from any financial institution on risks associated with derivatives activities.

Beyond the potential role of a systemic risk regulator, some have proposed further addressing risks from OTC derivatives by extending regulatory oversight to these instruments more broadly. For example, the Treasury Department, Federal Deposit Insurance Corporation (FDIC), and Group of Thirty Financial Reform Working Group (G30) have all recently called for a formal system of regulation and supervision for these markets.[3] The Treasury and FDIC proposals call

[2] Under current futures regulations, participants in the futures markets that hold positions at or above specific exchange or CFTC-set reporting levels must make daily reports to CFTC. Commodity traders or brokers that carry these accounts must make daily reports about the size of the position by commodity, by delivery month, and by whether the position is controlled by a commercial or noncommercial trader.

[3] U.S. Treasury, "Treasury Outlines Framework for Regulatory Reform," (Washington, D.C.: Mar. 26, 2009); Federal Deposit Insurance Corporation, "Statement of Sheila Bair, Chairman, Federal Deposit Insurance

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for central clearing of standard OTC derivative contracts along with strong regulation and supervision for non-standardized contracts. This would include rules regarding risk management, trade confirmation and reporting, margin and collateral practices, and other practices to increase transparency and minimize risk. The Treasury proposal also would strengthen eligibility requirements for all participants in OTC derivatives markets as well as establish recordkeeping and reporting requirements. The G30 framework would regulate OTC derivatives dealers, participants whose positions are systemically significant, and clearinghouses. All of the proposals would make information on large exposures and concentrations of risk available to the appropriate regulator.

In addition to increasing regulatory oversight of OTC derivatives, improved accounting and reporting standards could also potentially improve the transparency of these activities. The complex nature of derivatives makes the accounting and financial reporting associated with these instruments challenging. Derivatives meeting certain criteria fall under fair value accounting. The Securities and Exchange Commission's Office of the Chief Accountant recently conducted a study that concluded that the current fair value accounting standard—SFAS No. 157—should be improved, but should not be suspended. The study further stated that the improvement should come from a variety of measures including the issuance and application of best practices and enhanced disclosure in the financial statements. Recently, the Financial Accounting Standards Board issued three staff positions (FSPs) intended to provide additional application guidance and enhance disclosures regarding fair value in financial statements.[4]

Corporation on Modernizing Bank Supervision and Regulation before the Committee on Banking, Housing and Urban Affairs, U.S. Senate," (Washington, D.C.: Mar. 19, 2009); Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, D.C.: Jan. 15, 2009).

[4] FASB Staff Position No. 107-1 and APB 28-1, *Interim Financial Disclosures about Fair Value of Financial Instruments* (April 9, 2009); FASB Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 9, 2009); FASB Staff Position No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (April 9, 2009).

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"Where Were the Watchdogs:
The Financial Crisis and the Breakdown of Financial Governance"
Homeland Security and Governmental Affairs Committee
Chairman Joseph Lieberman
January 21, 2009

Good afternoon and welcome to our hearing today. As our nation begins work under our new President to recover from the worst financial crisis since the Great Depression, we must also ask how and why it happened. Is the existing U.S. financial regulatory system adequately equipped to protect consumers, investors, and our economy?

A new report by the Government Accountability Office that is the focus of today's hearing lays out a very persuasive case that the answer to that big question is no.

Over time, as the financial services sector has grown and moved in new directions, Congress has usually responded in a piecemeal fashion, grafting new regulatory agencies on top of one another.

As a result, responsibilities for overseeing the financial services industry are today shared by over 200 different regulatory agencies at the Federal and state level, not to mention numerous self-regulatory organizations, such as the stock exchanges.

GAO's report concludes that our current regulatory structure is outdated and unable to meet today's challenges and highlights several key changes in financial markets that have exposed significant gaps and limitations in our ability to protect the public interest.

Some of GAO's observations are familiar to members of this Committee. We have heard about the careless lending practices that led to the current sub-prime mortgage crisis, the increasing number of over-leveraged financial institutions that need to be bailed out by the government, the failures of credit-reporting agencies to provide credible ratings for increasingly complex financial products, and the inability of regulators to uncover, or in some way respond to the world's largest-ever Ponzi scheme.

It gives this Committee no satisfaction to note that some of these shortcomings were highlighted over six years ago in our investigation by the full Committee and the Permanent Subcommittee on Investigations following the collapse of Enron. Unfortunately these were just the tip of a regulatory iceberg. Then, we noted the inadequacies of the credit rating agencies and the failures of regulators to notice the red flags that warned of massive financial fraud.

Rather than contributing to the stability of financial markets, our fractured regulatory system encourages financial institutions to play regulators off against one another. New and complex financial products are created that bypass antiquated regulatory regimes. In certain derivatives markets, regulation is absent altogether. All in all, these problems surely contributed to the build-up of systemic risks and the eventual breakdown in credit and financial markets last year that has put millions of people out of work, destroyed so much of the savings and home values of the American people and broken our economic confidence in the future.

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We have called this hearing today to take a government-wide look at our existing structure of regulation of financial services. We have asked today's witnesses, Gene Dodaro, Acting Comptroller of GAO, Professor Howell Jackson of Harvard Law School and Professor Steven Davidoff of the University of Connecticut School of Law to tell us if the current regulatory system fails to adequately protect consumers, preserve the integrity of our markets, and protect the safety and soundness of important financial institutions.

Given the scope of the crisis we face today on top of the crises that we have gone through over recent years, including the Savings and Loan scandals, the dot-com bubble, and the Enron accounting mess, now is the time to think not just about regulatory reform, but about regulatory reorganization.

Personally, I have not yet concluded whether the way to fix our current regulatory structure will lie in establishing one super-regulatory agency, like that seen in other developed countries, or whether it will be wiser to simply improve the abilities of the regulators we currently have, or whether the answer is somewhere in between.

However, what I do know is that there are serious deficiencies in our current patchwork regulatory system, and before Congress can fix them wisely – and in a way that won't just respond to the last economic crisis but will respond to the next one – I think we must step back and carefully scrutinize how the pieces would best fit together. That is what I hope our Committee is best suited do.

President Obama has declared that reforming the current financial regulatory structure will be one of his top priorities. I welcome this. Any legislation in this regard will come out of the Senate Banking Committee. However, I believe that this Committee's unique authority concerning governmental organization and oversight, as well as the special investigative power of our Permanent Subcommittee on Investigations, requires us to get involved in this urgent review and will enable us to help the Senate reach the right conclusions about how we restructure our system of financial governance to prevent future financial crises that cause terrible economic pain.

Now, how will we do this, you ask? We can do this with a series of hearings and investigations, express our conclusions in a report, and offer amendments later in the year. This is a matter of importance and urgency to the country, and I do believe we have something to contribute. Thank you.

Senator Collins?

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Statement of
Senator Susan M. Collins

'Where Were the Watchdogs? The Financial Crisis and the Breakdown of Financial Governance'

Committee on Homeland Security and Governmental Affairs
January 21, 2009

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The spiraling financial crisis has harmed virtually every American family. December's job losses were the worst monthly decline since 1945 and drove the unemployment rate above seven percent. Individual retirement accounts and college savings accounts, as well as university endowments and public and private pension funds, have suffered huge losses. Consumer credit and mortgage availability have become more restricted.

In the past year, more than a million homes were foreclosed upon, and foreclosure proceedings are targeting two million more. Home prices are still falling, and at least 14 million households owe more on their mortgages than their homes are worth.

The current crisis has its roots in the financial system, where a combination of low interest rates, reckless lending, complex new instruments, securitization of assets, poor disclosure and understanding of risks, excessive leverage, and inadequate regulation poisoned the normal flows of credit and commerce.

The financial system itself has not escaped the carnage. A year ago, American capital markets were dominated by five large investment banking firms: Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs. Now they have failed, been sold to banks, or have converted to bank holding companies. Tens of thousands of banking and investment jobs have disappeared.

A year ago, we thought a TARP was for covering your roof after a hurricane. Now the Troubled Asset Relief Program, originally touted as a means for Treasury to buy troubled assets from banks, has morphed into a mechanism for buying hundreds of billions of dollars in bank preferred stock and warrants.

It is not sufficient for Congress to continue to infuse new money into the TARP, or simply to pass an economic-stimulus package. We must also ask how to repair our system of financial regulation to minimize the risk that another crisis such as this might build up undetected and unchallenged.

As we consider the options for reform, the Government Accountability Office's new report on financial regulation will be a valuable guidebook. It describes the structure of the current system, explains the system's inability to cope with shifting circumstanees, and proposes criteria for judging reforms.

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GAO's report sums up our challenge: "As the nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the nation's needs in the 21st century." That judgment confirms what this Committee has found in hearings on commodity speculation and derivatives trading: There are too many gaps between jurisdictions, too many financial entities and instruments that can create huge risks but are largely free from regulatory requirements, and too little attention paid to systemic risk.

We now understand that every day activities by mortgage brokers, hedge funds, over-the-counter traders, investment banks, Freddie Mac and Fannie Mae, and others dealing in mortgage-backed securities, credit-default swaps, and other instruments can create a crisis that affects virtually every home and business in America.

Yet, of the dozen federal agencies and hundreds of state agencies that are involved in financial regulation, not one is tasked with detecting and assessing systemic risks. We have seen the consequences of that flaw. The proliferation of unregulated and unreported credit-default swaps created spider webs of commitments, so that a few failures rippled into the destruction of major investment banks.

By accident or design, there are many key players in the modern financial-regulatory system who are unregulated or lightly regulated, including mortgage brokers, self-regulating exchanges and credit rating agencies, hedge funds, and nonbank lenders. Without additional transparency into their operations, a new systemic-risk monitor would find its mission difficult to achieve.

These difficulties have become so obvious that it is now common to hear government and industry officials, as well as academic experts, calling for a systemic-risk monitor and for a restructuring of regulatory agencies.

In November, I introduced a bill to correct two other glaring gaps in our regulatory system – the lack of explicit regulatory authority over investment-bank holding companies and the lack of transparency for credit-default swaps.

Regulatory reform is absolutely essential to restoring public confidence in our financial markets. America's consumers, workers, savers, borrowers, and investors deserve the protection of a new regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk-taking, and improves oversight, accountability, and transparency.

Our goals, therefore, must combine several vital objectives: stability for the financial system, safety and soundness regulation for institutions, strict protections for investors and consumers, transparency and accountability for transactions, and increased financial literacy for the public.

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In pursuit of these vital objectives, we must also take care not to stifle useful new products, prevent beneficial risk sharing, or create moral hazard by making failure impossible. Some firms deserve to die and have their assets pass into the hands of more capable managers. The challenge is to ease the turmoil caused by failing-but-important institutions without disrupting everything around them. In other words, we need better systems to prevent the development of catastrophic concentrations of risk at firms like Bear Stearns and AIG, and better systems to mitigate the collateral damage if they do fail.

A comprehensive plan of reform with clear goals, a system-wide focus, efficient regulation, flexible and adaptive powers, consistent treatment of parties and products, and minimal exposure for taxpayers may bear little resemblance to the intricate, yet fragmented, structure that has regulated this country's financial markets for many decades.

Mr. Chairman, America's financial crisis has spread far from Wall Street to affect the livelihoods of people all across America. We all know that people are angry about the crisis, about the failures of regulation, and about the bailouts. They rightly demand that we erect new defenses against a repeat. This hearing will help lay the groundwork for a new, more effective approach to financial regulation.

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Statement by Senator Carl Levin (D-Mich)

Before

Homeland Security and Governmental Affairs Committee

On

Where Were the Watchdogs?
The Financial Crisis and the Breakdown of Financial Governance

January 21, 2009

Today's hearing provides an opportunity to deepen our analysis of what has gone wrong with the U.S. financial system, and what reforms are needed not only to end the immediate crisis, but to rebuild our financial architecture and strengthen investor, consumer, and taxpayer protections.

This exercise is not a new one. History has proven time and again that markets are not self-policing. The Pecora hearings before a Senate Committee in the 1930s pulled back the curtain on the abuses that gave rise to the Great Depression. Hearings since then have documented a litany of abuses by financial firms trying to take advantage of investors and markets for private gain.

In recent years, for example, Congressional hearings -- including by the Permanent Subcommittee on Investigations which I chair -- showed how Enron cooked its books, deliberately distorted energy prices, and cheated on its taxes, becoming the seventh largest corporation in the country before its collapse. Our Subcommittee hearings also showed how leading U.S. financial institutions such as Citigroup, JPMorgan Chase, and Merrill Lynch willingly participated in deceptive transactions to help Enron inflate its earnings. Some of our other hearings have disclosed U.S. corporations engaged in misleading accounting, offshore tax abuses, excessive stock option payments, and other disturbing practices. Our 2007 hearing showed how a single hedge fund named Amaranth made massive commodity purchases on both regulated and unregulated energy markets to profit from distorted energy prices they helped generate, causing U.S. consumers to pay more. Our hearing last year showed how Lehman Brothers, Morgan Stanley, and others helped offshore hedge funds dodge payment of U.S. taxes on U.S. stock dividends by facilitating complex swap agreements and stock loan transactions. Other Congressional hearings have shown how Countrywide and others sold abusive mortgages, overcharged borrowers, and offloaded defective mortgage-based securities onto the market.

Part of the explanation for these recent abuses is a history of actions that have gradually weakened our financial regulatory system. This chart lists just a few of those actions over the last ten years, which have included blocking regulation of over-the-counter derivatives; repealing the Glass-Steagall wall separating banks, broker-dealers, and insurers; authorizing unregulated

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electronic commodity markets for large energy traders; weakening the capital requirements for broker-dealers; and more.

It hasn't been all one way. After the Enron scandal, we were able to enact the Sarbanes-Oxley Act that strengthened oversight of the accounting profession, required stronger financial controls, and made other improvements. Last year, we successfully closed the Enron loophole barring government oversight of electronic energy markets for large traders. But stronger market regulation has been the exception, not the rule, and had to be won despite naysayers claiming markets work best with minimal regulation. But the current crisis shows that minimal regulation is a recipe for disaster, an overhaul of Wall Street regulation is long overdue, and Congress needs to act now to fix a broken system.

As Congress and the new Administration begin the work of financial restructuring and our Committee begins to examine the issues, I would like to offer some observations about needed financial reforms. The first is that Congress needs to put a cop on the beat in every financial market with authority to police every type of market participant and financial instrument to stop abuses. We need to eliminate the statutory barriers, for example, that prohibit federal regulation of credit default swaps, hedge funds, and derivative traders. We also need to enact new limits on high risk activities including preventing banks from running their own hedge funds and requiring increased oversight of offshore activities. Congress also needs to reduce the concentration of risk to the taxpayer by preventing any one bank from holding more than 10% of U.S. financial deposits, and to institute new protections to stop financial institutions from profiting from practices that abuse investors and consumers.

Let me explain.

Bigger is Not Better. To move forward it is important first to look back. Until relatively recently, U.S. law prohibited federally-chartered banks from branching across state lines. Instead, U.S. banking consisted primarily of thousands of modest-sized banks tied to local communities. In contrast to other countries which typically have had a few dozen banks or less, the United States is home to more than 15,000 banks, thrifts, and credit unions. The United States is almost alone in the world in its large number of banks, and the benefits are clear. When one bank suffers losses, the government can shut it down, protect depositors, and avoid damage to the banking system and economy. Decentralized banking also promotes competition, spreads credit through the marketplace, and prevents undue concentrations of financial power.

In the mid 1990s, however, we began to move away from the U.S. tradition of modest-sized banks. In 1994, for the first time, Congress authorized interstate banking, which allowed federally chartered banks to open branches nationwide. In 1999, Congress repealed the Glass-Steagall wall separating banks, securities firms, and insurance companies, and allowed them to merge. Most of us agreed to allow this wall to come down only on the understanding that strong SEC regulation of bank's trading activities would follow. But that didn't happen.

In 2000, deregulation went further. The Enron loophole allowed U.S. financial institutions to start trading derivatives on unregulated electronic energy markets for large traders. In 2004, the SEC relaxed capital requirements for large securities firms, allowing them to grow even larger using borrowed funds. Affiliated derivative traders, hedge funds, and private equity

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shops began operating outside the federal regulatory framework, becoming ever more powerful market participants. New financial instruments such as credit default swaps also gained favor, again outside regulatory constraints.

Each of these steps helped pave the way for a relatively small number of U.S. firms to become giant financial conglomerates involved in collecting deposits, financing loans, trading commodities, and buying, selling, issuing, underwriting, and insuring billions of dollars in stock, debt instruments, insurance policies and derivatives. When one of these financial mammoths got into trouble, it could not be easily closed. Now that many are in trouble, their problems have severely damaged U.S. credit markets, destabilized the stock market, and even threatened the viability of the U.S. financial system.

The Bush Administration's response to this crisis has been to allow some of the biggest institutions to expand even more. With the blessing of regulators, Bank of America swallowed up Merrill Lynch. JPMorgan Chase took over Washington Mutual. Wells Fargo purchased Wachovia. Treasury committed $125 billion in new capital to the nine largest U.S. financial institutions, and has encouraged them to use the funds, not just to unlock credit markets or repair troubled assets, but to buy up still more financial institutions.

As lawmakers begin to revamp our system of financial regulation, one guiding principle should be to remember the roots of American financial strength, which includes reliance on a network of financial institutions, without behemoths that are too big to be allowed to fail and require massive taxpayer bailouts when problems arise. While it may be too late to restore the banking landscape of 15 years ago, it is not too late to curb further abuse. One of the key constraints is a statutory prohibition on approving mergers of financial institutions with more than 10 percent of U.S. bank deposits. That law should be expanded to prohibit any institution from exceeding the 10 percent limit and to include deposits of all types. Another suggestion is to prohibit banks from owning hedge fund or private equity affiliates, and to limit the trading they do on their own behalf.

Put a Cop on Every Beat. Despite the evidence that markets are not self-policing, some policymakers have invoked the mantras of free markets, financial innovation, and financial self-interest to argue for minimal market regulation. During the past decade, these arguments largely succeeded. The result today is a wide array of gaps in U.S. financial regulation exempting various types of financial instruments, financial institutions, and even whole markets from government oversight. Those gaps need to be closed.

The 2000 Commodity Futures Modernization Act, for example, currently bars federal regulation of over-the-counter derivatives markets, and prohibits SEC and CFTC regulation of all types of swap agreements, including credit default swaps that have now evolved into a $50 trillion market. Holding companies of major U.S. securities firms are able to operate outside of SEC regulation. So can some derivatives traders. Hedge funds, carefully designed to evade SEC rules, have become unregulated heavyweights in U.S. markets and are the last major U.S. financial players without any anti-money laundering obligations.

Another regulatory gap involves the so-called "revolving door" between the regulating agencies and the financial institutions they're charged with overseeing. Too often, oversight suffers because regulators are positioning themselves for lucrative jobs in the private sector. An

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investigation by the Subcommittee found that a senior bank examiner charged with overseeing Riggs Bank when the bank was conducting questionable transactions for former Chilean President Augusto Pinochet and the government of Equatorial Guinea, retired from his agency and went to work for Riggs Bank three days later. Following this investigation, Congress passed a law imposing a one-year cooling off period before a senior federal bank examiner can take a job with a financial institution that he or she was responsible for overseeing. Similar cooling-off periods should be instituted for other financial regulators.

Perhaps the most glaring regulatory gap of all involves offshore jurisdictions. About 50 offshore jurisdictions operate globally, attracting clients by trumpeting secrecy laws, minimal or no taxation, and little or no financial regulation. Some are on international blacklists for failing to cooperate with international law enforcement efforts to stop tax evasion or money laundering. Offshore abuses alone cost the U.S. Treasury an estimated $100 billion in unpaid taxes each year. Yet the United States allows offshore hedge funds, corporations, trusts, and other entities to open accounts at our banks, invest in our markets, provide financial services to U.S. clients, and participate in transactions designed to dodge U.S. taxes. Moreover, we allow U.S. financial institutions to open offshore branches immune to U.S. capital requirements, engage in offshore transactions hidden from investors, and incur risk from undisclosed offshore obligations and holdings.

It is time to close these and other glaring gaps in U.S. financial regulation. Lawmakers need to eliminate the statutory barriers that prohibit federal regulation of financial activities, enact rules to protect investors and market integrity, and put a cop on every beat with clear authority to enforce those rules and stop abuses. At a minimum, federal regulation and the cop on the beat need to be authorized to police unregulated commodity trades, swap agreements and other derivatives, hedge funds, investment bank holding companies, derivative traders, and offshore entities.

Limit High Risk Activity. Another critical deficiency in the existing U.S. regulatory system is its failure to impose effective limits on high risk financial activity by regulated financial institutions. Over the past 10 years, regulatory controls over high risk investments were relaxed and oversight by regulators was largely absent.

For example, for 30 years, from 1975 to 2004, the SEC required securities firms to comply with a net capital rule containing bright-line requirements for calculating capital reserves. The rule worked well. But in 2004, the SEC added an "alternative" to the rule and allowed the largest securities firms to use a less strict "risk-based" approach. In response, the largest securities firms used the alternative to lower their capital reserves, increase borrowing, and buy more risky investments. When trouble hit, they generally had insufficient capital to weather the storm.

On the bank side, capital requirements were stronger, but it is clear that they remain insufficient. After the repeal of Glass-Steagall, many banks increased the volume of their securities transactions, not only for their clients but on their own behalf. Many banks also engaged in higher risk investments, buying subprime mortgages and collateralized debt obligations, entering into credit default swaps, and trading over-the-counter derivatives. Regulators allowed "well capitalized" banks to take on more risk, even when missteps by large banks could necessitate a taxpayer bailout. The result has been a capital and liquidity crisis.

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In addition to inadequate capital and liquidity requirements, federal regulators failed to stop individual financial institutions from incurring excessive risk. In 2002, after the Enron debacle, my Subcommittee convinced federal bank and securities regulators to conduct a joint review of complex structured financial transactions at the dozen largest banks and securities firms and in, 2004, propose new guidance to limit problems. Three years later, in 2007, however, the regulators issued final guidance that was much weaker. The regulators eliminated, for example, provisions warning against the use of abusive transactions; provisions specifying the steps that corporate boards, senior management and legal counsel should take to prevent abuses; provisions detailing good recordkeeping practices; and provisions recommending establishment of a board policy on acceptable risk levels from complex structured transactions. In effect, the 2007 guidance issued by the bank regulators and the SEC dismantled many of the risk protections proposed in 2004. The SEC also set up, but then underfunded, an office intended to detect and prevent systemic risk in the financial system. At the same time, bank regulators, despite having authority to ensure a bank's sound operation and screen new bank products and investments, failed to limit bank participation in high-risk activity.

The agencies' failure to use the regulatory authority they had was due in part to the Bush Administration's philosophical opposition to market controls and uncritical support of "financial innovation." Banks were allowed to trade exotic financial instruments and set up their own hedge funds and private equity affiliates. In addition, government oversight was hindered by the 2000 statutory prohibition already mentioned barring federal regulation of swap agreements and the over-the-counter derivative markets. This prohibition meant, for example, that the SEC could not require public companies to calculate, disclose, or limit their swap holdings.

One consequence was the surprise announcement that AIG, one of the largest companies in America, had issued credit default swaps insuring the repayment of debt totaling an estimated $440 billion. As the holding company for a thrift, AIG is regulated by the Office of Thrift Supervision as well as the SEC, but neither agency ever placed a limit on its credit default swaps, because the law barred them from doing so. Even Alan Greenspan now admits that doesn't make sense. The fear that other companies also have undisclosed credit default obligations is partially responsible for lenders' reluctance to lend funds to each other, and to businesses and consumers.

In addition to these regulatory failures to control risk, another key contributor to the current crisis is the credit rating agencies that repeatedly issued safe credit ratings for high-risk investments. Recent Congressional hearings disclosed the internal misgivings at the top three credit rating agencies, Moody's, Standard & Poor's, and Fitch, about their own ratings. Internal emails contained the following: "Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both." "[Our rating] model def[initely] does not capture half of the ... risk. ... We should not be rating it." "[Credit rating agency professionals are] continually 'pitched' by bankers, issuers, investors ... whose views can color credit judgment." "Let's hope we are all wealthy and retired by the time this house of cards falters." Over the past year, triple-A bonds have been re-categorized as junk bonds, and bank investments have plummeted in value. The credibility of the credit rating agencies has plummeted as well, with a paralyzing effect on markets.

To stop high risk investments from damaging the U.S. financial system, lawmakers could strengthen capital and liquidity requirements for banks, restore the net capital rule for securities

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firms, and require procedures to oversee and limit high risk investments, including credit default swaps, over-the-counter derivatives, and offshore transactions. Asset backed securities could be rejuvenated by including new investor protections, such as those used in credit card securitizations which require the issuer to continue to hold a financial stake in the securities offered to the public. As mentioned earlier, banks could also be prohibited from operating their own hedge fund or private equity affiliates that, by design, target high-risk investments.

Another sensible reform would be to impose strong due diligence obligations on all persons involved in issuing bonds and other securities for sale, including underwriters, distributors, and rating agencies. Action should also be taken to end the conflicts of interest that distort credit ratings, either by requiring credit rating agencies to be paid by investors or, if that wouldn't support a rating system, by setting up a new process in which those seeking ratings pay fees to a government-sponsored oversight board, similar, perhaps, to the existing accounting oversight board, to register, police, and compensate credit rating agencies. To stop offshore abuses, the Levin-Coleman-Obama Stop Tax Haven Abuse Act offers multiple provisions to end the use of offshore tax havens to dodge taxes or hide financial activity from regulators and the public.

Main Street Over Wall Street. A final principle to guide the restructuring effort is to strengthen investor, consumer, and taxpayer protections to stop financial institutions from profiting from practices that abuse investors or consumers. To date, hundreds of billions of taxpayer dollars have gone to recapitalize Wall Street, purchase troubled assets, and insure financial instruments. Little has been spent to protect Americans on Main Street from unfair financial practices.

Investor protections, at a minimum, should include reliable accounting rules, executive pay limits, and stronger anti-fraud protections by reversing the Stoneridge case. Some in the corporate world don't like tough accounting rules, because those rules disclose financial problems. But that is exactly what investors have a right to know. Some corporate leaders oppose executive pay limits, because they want to continue to pull down outsized compensation from company coffers in good times and bad. But shareholders should be able to limit excessive executive pay at the companies they own, and taxpayers shouldn't have to subsidize million-dollar pay.

In Stoneridge, the Supreme Court determined that shareholders are barred by federal law from suing third parties that help public companies commit fraud, and must instead rely on federal regulators to punish wrongdoing and recover funds. Given limited federal resources, however, that ruling means, in too many cases, banks, accounting firms, lawyers and others will be able to aid and abet corporate fraud, and shareholders will have no legal recourse. That isn't fair, and it undermines investor confidence in U.S. markets.

Homeowners also lack protection against unfair financial practices. The subprime crisis is the product, in part, of predatory lending practices directed at less sophisticated borrowers. Those practices included subprime mortgages sold to borrowers who qualified for better loans, use of dishonest appraisals, and the sale of mortgages containing exploding interest rates, unfair prepayment penalties, and excessive fees. Selling loans with inherently unfair elements should not be allowed. In addition, mechanisms need to be developed to make it easier to reform unfair

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mortgages after they are issued. It is also important to create incentives for financial institutions to issue loans that can be paid back, rather than nonviable loans issued primarily to collect fees.

Consumers also need protection from abusive practices by credit card issuers, including the five large banks that control 80% of the credit card market, Bank of America, Capital One, Citigroup, Discover, and JPMorgan Chase. Unfair credit card practices include interest rates as high as 30%, excessive fees, interest rate hikes on consumers with years of on-time payments, higher interest rates applied retroactively, charging interest for debt paid on time, bills sent out with insufficient time to make a payment, and applying consumer payments in ways that maximize debt. These abusive lending practices mire too many American families in debt.

Solutions to these problems are at hand. Legislation already exists that would put an end to predatory lending and credit card abuses; give shareholders a say on executive pay and a voice on corporate boards; and place new limits on corporate stock option and executive pay. Legislation reversing Stoneridge would restore civil liability for aiders and abettors of corporate fraud. Honest accounting can be preserved primarily by rejecting attempts to weaken U.S. rules, including calls to abandon mark-to-market valuation, to replace U.S. auditing and accounting standards with weaker international standards, or to eliminate Sarbanes-Oxley requirements for strong internal controls at companies. Lawmakers should also consider establishing a financial safety commission to evaluate new financial products aimed at consumers and prevent abusive products from going on the market.

Conclusion. The current financial crisis has exposed fundamental flaws in U.S. financial regulation and demonstrates why it is an absolute necessity to correct them. One set of issues to be confronted involves deciding which regulatory agency should exercise what type of oversight. But as important as that set of issues is a more basic one – whether all types of market participants, financial instruments, and markets should be subject to regulation and oversight. In my view, Congress and the new Administration should use this opportunity to close all the regulatory gaps that now weaken our laws; put a cop on every financial beat; and strengthen investor, consumer, and taxpayer protections, including by limiting the size of individual banks. I look forward to the testimony today to learn more about how to move America forward.

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A DECADE OF WEAKENING FINANCIAL REGULATION

Oct. 1998	At the request of the SEC, Treasury, and Federal Reserve, Congress blocks funding for any CFTC regulation of over-the-counter derivatives.
Nov. 1999	Gramm-Leach-Bliley Act repeals 1933 Glass-Steagall wall separating banks, broker-dealers, and insurers.
Dec. 2000	Commodity Futures Modernization Act prohibits swaps regulation and opens Enron loophole allowing unregulated energy markets for large traders.
Aug. 2003	SEC delays requiring auditors of private broker-dealers to register with Public Company Accounting Oversight Board.
Oct. 2003	SEC proposes but never adopts rule on shareholder nominations of directors.
June 2004	SEC weakens net capital rule for securities firms.
June 2006	Court of Appeals invalidates SEC regulation requiring hedge fund registration.
Jan. 2007	SEC and bank regulators weaken guidance for oversight of complex structured finance products.
July 2007	SEC eliminates 1938 uptick rule that had put certain limits on short stock sales.
Dec. 2007	SEC allows foreign companies trading on U.S. exchanges to use international financial reporting standards without a reconciliation to U.S. generally accepted accounting principles.
Jan. 2008	Supreme Court issues Stoneridge decision barring shareholder suits against third parties that help public companies commit fraud.

Prepared by Senator Levin
January 2009

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"Where Were the Watchdogs:
Systemic Risk and the Breakdown of Financial Governance"
Homeland Security and Governmental Affairs Committee
Chairman Joseph Lieberman
March 4, 2009

Good morning and welcome to our hearing today, the second in our series examining the structure of our nation's financial regulatory system in the aftermath of its obvious failure to protect us from the economic crisis we are experiencing now.

We are undertaking this series of hearings pursuant to the Committee's traditional "Governmental Affairs" mission. Under Senate rules, this Committee has responsibility for the "Organization and reorganization of the executive branch of the Government," as well as for the study of "the efficiency, economy, and effectiveness of all agencies and departments of the Government." By examining what changes should be made to improve and modernize the organization of the federal financial regulatory system, we are not only fulfilling these responsibilities but we hope to be preparing ourselves to make recommendations to our colleagues on the Senate Banking Committee. We see our unique role here as reaching a judgment about the structures not so much the day to day regulation.

And as we learned from our last hearing on this subject, our nation's outdated and fragmented system of financial regulation is especially ill-suited to handle risks that occur across many different types of institutions, markets, and activities.

Today's hearing will examine the pros and cons of creating a systemic risk regulator for the financial services industry – and by "systemic risk", I mean the risk that a failed institution, a risky activity or a particular event could broadly affect the financial system rather than just one institution or one activity.

As we concentrate our efforts toward recovering from the greatest financial crisis since the Great Depression, we cannot ignore the fact that there is no one government agency or market participant responsible for monitoring systemic risks to the integrity of our entire financial system.

This bears repeating. In our current financial regulatory structure, there is no agency, board, or overseer responsible for regulating the entirety of our financial system - across instruments, markets, and geographical borders - asking questions and engineering solutions to prevent systemic risks from becoming systemic financial failures.
That is a very unsettling fact.

Many experts believe this gap should be bridged by creation of a "systemic risk regulator" who would supervise the financial system holistically. Federal Reserve Chairman Ben Bernanke has referred to this entity as a "macro-prudential" regulator.

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Part of the reason our current watch dogs failed is because each has just a piece of the system to oversee. What we need is a watchdog with a universal perspective, a complete picture of the variety of institutions and activities that pose the greatest risks to our economy.

For as long as there have been markets, there have been speculative bubbles and resulting financial crises. But through sensible regulation I do believe we can improve the ability of our financial system to prevent and withstand severe shocks, reduce vulnerability to extreme crises, and limit the damage to our economy when a crisis occurs.

As always, the devil is in the details – and it is those details that we hope to illuminate today.

If we determine that we need a governmental agency focused on the issue of systemic risk, we must then figure out how to design such an entity. Can the role of monitoring and responding to systemic risks be accomplished within our existing regulatory structure, or should Congress create a new body to act as systemic risk regulator? What would be the responsibilities of this body? What tools would it need to meet those responsibilities? And what would its relationship be with other regulators?

At today's hearing we have a panel of witnesses who have thought constructively about these issues. Dr. Robert Litan, of the Kauffman Foundation, Damon Silvers, a member of the TARP Congressional Oversight Panel, and Robert Pozen, Chairman of MFS Management, a well respected financial manager. Among other things, we have asked these distinguished gentlemen to consider whether a systemic regulator is necessary and, if so, what sorts of risks, activities, and institutions should come within its purview, and what authorities such a regulator would require.

We cannot expect the creation of a systemic regulator to be a universal remedy for all that ails our financial services industry today.

First, we must enact sensible regulation for day to day supervision of all our financial institutions so that a systemic regulator would have a sensible structure to oversee.

Given our current situation, it is fair to say that the cost of a systemic meltdown is far greater than the cost of reasonable and prudent regulation. So, I will ask our witnesses whether they believe our future economic growthdepends on the creation of a systemic risk regulator, and, if so, where in our government would it work best.

Senator Collins?

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Statement of
Senator Susan M. Collins

'Where Were the Watchdogs? Systemic Risk and the Breakdown of Financial Governance'

Committee on Homeland Security and Governmental Affairs
March 4, 2009

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Today the Committee examines the need to establish a systemic-risk monitor that might have helped prevent the financial crisis that our nation now confronts.

America's financial crisis has spread from Wall Street to Main Street, affecting the livelihoods of people all across the country. The American people deserve the protection of a new regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk-taking, and improves oversight, accountability, and transparency.

Our financial regulators should have had the ability to see the current collapse coming and to act quickly to prevent or mitigate its impacts. Unfortunately, oversight gaps in our existing system, risky financial instruments with little or no regulatory oversight, and a lack of attention to systemic risk undermined our financial markets.

When the entire financial sector gambled on the rise of the housing market, no single regulator could see that everyone – from mortgage brokers to credit default swap traders – was betting on a bubble that was about to burst. Instead, each agency viewed its regulated market through a narrow tunnel, missing the total risk that permeated our financial markets.

When the housing market collapsed, the impact set off a wave of consequences. Borrowers could no longer refinance their mortgages, credit markets were frozen, consumer demand plummeted, businesses were unable to make payments or meet payrolls, and workers were laid off, making it difficult for even more families to pay their mortgages.

In Maine, the unemployment rate reached a 16-year high of seven percent at the end of 2008. There were also more than 2,800 foreclosures in Maine, not that many compared to other states, but nearly a 900 percent increase from the previous year.

This financial crisis has harmed virtually every American family. Taxpayers have financed bailout after bailout of huge financial institutions at the cost of trillions of dollars.

These drastic and expensive rescues might not have occurred had there been a regulator evaluating risk to the financial system as a whole. Such a regulator could have recognized the house of cards being constructed in our financial markets. While there are many regulators within the financial system, not one of them had the ability to evaluate risk across the entire

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financial system. For example, the Federal Reserve could clearly see the large number of securitized mortgages of banks within its jurisdiction, but had no visibility into the full extent of securitization at non-federally regulated banks or financial institutions regulated by the SEC.

What was needed then, and is needed now, is a systemic-risk regulator. The GAO and other government and industry officials, as well as academic experts, have called for the creation of such a monitor.

The creation of a systemic-risk monitor raises many new questions, however, about its structure and authority. Should an existing regulator like the Federal Reserve be charged with monitoring systemic risk, or should a new entity be tasked with the responsibility? For example, should a council composed of the heads of our nation's financial regulatory agencies be assigned this duty?

We must consider what should occur when systemic risk is detected in the future. Should a systemic-risk entity be empowered to issue regulations, to review and approve new financial instruments, and to fill in regulatory "black holes" that result from overlapping or narrow agency jurisdictions? Or should the systemic-risk monitor be required to work through existing regulators?

In designing a better regulatory framework, we must take care not to create a moral hazard by making failure impossible, to stifle useful new products, or to prevent beneficial risk sharing. The challenge is to ease the turmoil caused by failing-but-important institutions without setting off a cascade of trouble for otherwise healthy entities. In other words, we need a better system to prevent the development of catastrophic concentrations of risk at firms like Bear Stearns and AIG, and better systems to mitigate the collateral damage if they do fail.

Our goals must combine several vital objectives: stability for the financial system, safety and soundness regulation for institutions, protections for investors and consumers, transparency and accountability for transactions, and increased financial literacy for the public. Significant regulatory reforms are required to restore public confidence and to ensure that lack of regulation does not allow such a crisis in the future. Hearings like this will help lay the groundwork for this new, more effective approach to financial regulation.

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"Where Were the Watchdogs?
Financial Regulatory Lessons from Abroad"
Homeland Security and Governmental Affairs Committee
Chairman Joseph Lieberman
May 21, 2009

Good morning and welcome to our hearing today - "Where Were the Watchdogs? Financial Regulatory Lessons from Abroad." This is our Committee's third in a series of hearings examining the structure of our financial regulatory system; how that flawed structure contributed to the system's failure to anticipate the current economic crisis; and, most importantly, what kind of structure is needed to strengthen financial oversight for the future.

As we learned from previous hearings, our current regulatory system has evolved in a haphazard manner over the last 150 years — largely in response to whatever the latest crisis was to hit our nation and threaten its financial stability.

As a result, we have a financial regulatory system that is both fragmented and outdated. Numerous federal and state agencies share responsibility for regulating financial institutions and markets, creating redundancies and gaps over significant activities and businesses such as consumer protection enforcement, hedge funds, and credit default swaps. Our current crisis has clearly exposed many of these problems.

To strengthen our financial regulatory system and protect us from future crises, an array of interested parties - academics, policymakers, and experts - from across the political spectrum has called for significant reorganization.

As we move forward and consider our options, it makes sense to examine the experiences of other nations around the world that have had similar experiences. That is the primary purpose of today's hearing.

Over the past few years the United Kingdom, Australia, and a number of other countries have dramatically reformed their financial regulatory systems. They have merged agencies, reconsidered their fundamental approaches to regulation, and streamlined their regulatory structures. Many experts believe that these reforms have resulted in a more efficient use of regulatory resources and more clearly defined roles for regulators. And even though the U.S. economy is vastly different in size and scope from all others, there is still much we can learn by studying the examples of our free market partners.

We have an impressive panel of witnesses today, each of whom has thought extensively about the different ways in which a country can structure its financial

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regulatory system. And I would imagine that you all bear the scars of trying to change the regulatory status quo.

As our witnesses know, reorganizations are complicated and difficult. Our committee learned this first hand through its role in creating and overseeing the Department of Homeland Security and in reforming our nation's intelligence community in response to 9/11. But reorganizations can also pay dividends, resulting in better coordination, greater efficiency, and more transparency.

Today we will hear if other countries that dared to restructure their financial regulatory systems have earned those dividends and how their lessons learned may be applied here in the United States.

I recognize that, by itself, restructuring our financial regulatory system will not solve all of our current problems or necessarily prevent future crises. That may well be an impossible task. But I know that we will be better off in the future if we reorganize our regulatory structures , not just reform the content of our regulations.

I am confident in the work that my colleagues on the Senate Banking Committee are doing to address the weaknesses in our financial regulations. Improving consumer protections, addressing systemic risks, and regulating derivatives are all necessary steps to ensuring the vitality of our financial services industry and our overall economy.

But the underlying regulations and the overarching structure are tightly interwoven. I firmly believe that if we want to minimize the likelihood of severe financial crises in the future, we need to reform our regulations *AND* improve the architecture of our financial regulators.

As Treasury Secretary Geithner and the Obama Administration prepare to announce their own plan for comprehensive reform in the coming weeks, the testimony presented here today will help ensure that we are cognizant of what has, and has not, worked abroad. Thank you.

Senator Collins?

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First we will hear from **David Green.** Mr. Green was Head of International Policy at the UK's Financial Services Authority after having previously spent three decades at the Bank of England. Mr. Green currently works for England's Financial Reporting Council.

Next we have **Jeffrey Carmichael**, the inaugural chairman of the Australian Prudential Regulation Authority, which had responsibility for regulating and supervising banks, insurance companies and pension funds. Dr. Carmichael currently works in Singapore as the CEO of Promontory Financial Group, Australasia.

Third is **Edmund Clark**, President and CEO of the TD Bank Financial Group in Canada. Mr. Clark has had a long career in both the Canadian government and private industry.

Finally, we will hear from **David Nason**, a key contributor to the Treasury Department's March 2008 Blueprint for a Modernized Financial Regulatory Structure. Mr. Nason works for Promontory Financial Group here in DC.

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Statement of
Senator Susan M. Collins

'Where Were the Watchdogs? Financial Regulatory Lessons from Abroad'

Committee on Homeland Security and Governmental Affairs
May 21, 2009

★ ★ ★

This is the third in a series of hearings held by this Committee to examine America's financial crisis. Our prior hearings have reviewed the causes of the economic crisis, and whether a systemic-risk regulator and other reforms might have helped prevent it.

Testimony at these hearings has demonstrated that for the most part, financial regulators failed to foresee the coming financial meltdown. No one regulator was responsible for the oversight of all the sectors of our financial market, and none of our regulators alone could have taken comprehensive, decisive action to prevent or mitigate the impact of the collapse. These oversight gaps and the lack of attention to systemic risk undermined our financial markets. Congress and the Administration must act to help prevent collapses like this in the future.

Based on our prior hearings and after consulting with a wide range of financial experts, I introduced the Financial System Stabilization and Reform Act in March. The bill would establish a Financial Stability Council that would be charged with identifying and taking action to prevent or mitigate systemic threats to our financial markets. The Council would help ensure that high-risk financial products and practices could be detected in time to prevent their contagion from spreading to otherwise healthy financial institutions and markets.

This legislation would fundamentally restructure our financial regulatory system, help restore stability to our financial markets, and begin to rebuild the public confidence in our economy.

The concept of a council to assess overall systemic risk has garnered support from within the financial regulatory community. The National Association of Insurance Commissioners, SEC Chair Mary Shapiro and FDIC Chair Sheila Bair are among those who support creating some form of a systemic risk council, while avoiding an excessive concentration of power in any one financial regulator.

As we continue to search for solutions to this economic crisis, it is instructive also to look outside our borders at the financial regulatory systems other nations use.

The witnesses we will hear from today will testify about the financial regulatory systems of the United Kingdom, Canada, and Australia. They also will provide a broader view of global financial structures. We can learn some valuable lessons from studying their best practices.

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Canada's banking system, for example, has been ranked as the strongest in the world, while ours is ranked only 40th.

America's Main Street small businesses, homeowners, employees, savers, and investors deserve the protection of an effective, regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk-taking, and improves oversight, accountability, and transparency. Our ongoing investigation will continue to shed light on how this current crisis evolved and help focus attention on the reforms needed to restore the confidence of the American people in our financial system.

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United States Government Accountability Office

GAO

Report to Congressional Addressees

January 2009

FINANCIAL REGULATION

A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System



GAO-09-216

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Highlights

Highlights of GAO-09-216, a report to congressional addressees

January 2009

FINANCIAL REGULATION

A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

Why GAO Did This Study

The United States and other countries are in the midst of the worst financial crisis in more than 75 years. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.

To help policymakers better understand existing problems with the financial regulatory system and craft and evaluate reform proposals, this report (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have created challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, GAO synthesized existing GAO work and other studies and met with dozens of representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. Twenty-nine regulators, industry associations, and consumer groups also reviewed a draft of this report and provided valuable input that was incorporated as appropriate. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

To view the full product, including the scope and methodology, click on GAO-09-216. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. As the nation finds itself in the midst of one of the worst financial crises ever, the regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s.

Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system.

- First, regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks. The portion of firms operating as conglomerates that cross financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.
- Second, regulators have had to address problems in financial markets resulting from the activities of large and sometimes less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.
- Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

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Highlights of GAO-09-216 (continued)

As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. As early as 1994, GAO identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products. Since then, GAO has described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs. This report offers a framework for crafting and evaluating regulatory reform proposals; it consists of the following nine characteristics that should be reflected in any new regulatory system. By applying the elements of this framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

Characteristic		Description
✓	**Clearly defined regulatory goals**	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
✓	**Appropriately comprehensive**	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
✓	**Systemwide focus**	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
✓	**Flexible and adaptable**	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
✓	**Efficient and effective**	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
✓	**Consistent consumer and investor protection**	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
✓	**Regulators provided with independence, prominence, authority, and accountability**	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.
✓	**Consistent financial oversight**	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
✓	**Minimal taxpayer exposure**	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO.

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Abbreviations

BFCU	Bureau of Federal Credit Unions
CDO	collateralized debt obligation
CEC	Commodity Exchange Commission
CFTC	Commodity Futures Trading Commission
CSE	Consolidated Supervised Entity
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FHFB	Federal Housing Finance Board
FHLBB	Federal Home Loan Bank Board
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
FTC	Federal Trade Commission
GFA	Grain Futures Administration
GLBA	Gramm-Leach-Bliley Act of 1999
GSE	government-sponsored enterprise
IMF	International Monetary Fund
LTCM	Long Term Capital Management
NAIC	National Association of Insurance Commissioners
NCUA	National Credit Union Administration
NRSRO	nationally recognized statistical rating organization
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OTC	over-the-counter
OTS	Office of Thrift Supervision
PCAOB	Public Company Accounting Oversight Board
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

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United States Government Accountability Office
Washington, DC 20548

January 8, 2009

Congressional Addressees

The United States is in the midst of the worst financial crisis in more than 75 years. In recent months, federal officials have taken unprecedented steps to stem the unraveling of the financial services sector by committing trillions of dollars of taxpayer funds to rescue financial institutions and restore order to credit markets, including the creation of a $700 billion program that has been used so far to inject money into struggling institutions in an attempt to stabilize markets.[1] This current crisis largely stems from defaults on U.S. subprime mortgage loans, many of which were packaged and sold as securities to buyers in the United States and around the world. With financial institutions from many countries participating in these activities, the resulting turmoil has afflicted financial markets globally and has spurred coordinated action by world leaders in an attempt to protect savings and restore the health of the markets. While much of policymakers' attention understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.[2]

The current U.S. regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with the major developments that have occurred in financial markets and products in recent decades. In particular, the current system was not designed to adequately oversee today's large and interconnected financial institutions, whose activities pose new risks to the institutions themselves as well as risk to the broader financial system—called systemic risk, which is the risk that an event could broadly effect the financial system rather than just one or a few institutions. In addition, not all financial activities and institutions fall

[1]For more information about these activities, see GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, GAO-09-161 (Washington, D.C.: Dec. 2, 2008).

[2]Throughout this report, we use the term "financial regulatory system" to refer broadly to both the financial regulatory structure—that is, the number and organization of financial regulatory agencies—as well as other aspects of financial regulation, including agency responsibilities, and mechanisms and authorities available to agencies for fulfilling such responsibilities.

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under the direct purview of financial regulators, and market innovations have led to the creation of new and sometimes very complex products that were never envisioned as the current regulatory system developed. In light of the recent turmoil in financial markets, the current financial regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century.

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the likelihood that the U.S. will experience another financial crisis similar to the current one. As a result, considerable debate is under way over whether and how the current regulatory system should be changed, including calls for consolidating regulatory agencies, broadening certain regulators' authorities, or subjecting certain products or entities to more regulation. For example, in March 2008, the Department of the Treasury (Treasury) proposed significant financial regulatory reforms in its "Blueprint for a Modernized Financial Regulatory Structure," and other federal regulatory officials and industry groups have also put forth reform proposals.[3] Under the Emergency Economic Stabilization Act, Treasury is required to submit to Congress by April 30, 2009, a report with recommendations on "the current state of the financial markets and the regulatory system."[4] As these and other proposals are developed or evaluated, it will be important to carefully consider their advantages and disadvantages and long-term implications.

To help policymakers weigh the various proposals and consider ways in which the current regulatory system could be made more effective and efficient, we prepared this report under the authority of the Comptroller General. Specifically, our report (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have raised challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and

[3]See Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Washington, D.C., March 2008); Financial Services Roundtable, *The Blueprint for U.S. Financial Services Competitiveness* (Washington, D.C., Nov. 7, 2007); Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, "Reducing Systemic Risk in a Dynamic Financial System" (speech, New York, June 9, 2008); and Ben S. Bernanke, Chairman, Federal Reserve, "Reducing Systemic Risk" (speech, Jackson Hole, Wyo., Aug. 22, 2008).

[4]Pub. L. No. 110-343, § 105(c).

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others to craft or evaluate potential regulatory reform efforts going forward. This report's primary focus is on discussing how various market developments have revealed gaps and limitations in the existing regulatory system. Although drawing on examples of events from the current crisis, we do not attempt to identify all of the potential weaknesses in the actions of regulators that had authority over the institutions and products involved.

To address these objectives, we synthesized existing GAO work on challenges to the U.S. financial regulatory structure and on criteria for developing and strengthening effective regulatory structures.[5] We also reviewed existing studies, government documents, and other research for illustrations of how current and past financial market events have exposed inadequacies in our existing financial regulatory system and for suggestions for regulatory reform. In a series of forums, we discussed these developments and the elements of a potential framework for an effective regulatory system with groups of financial regulators of banking, securities, futures, insurance, and housing markets; representatives of financial services industry associations and individual financial institutions; and with selected consumer advocacy organizations, academics, and other experts in financial markets issues. The work upon which this report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008. A more extensive discussion of our scope and methodology appears in appendix I.

Background

While providing many benefits to our economy and citizens' lives, financial services activities can also cause harm if left unsupervised. As a result, the United States and many other countries have found that regulating financial markets, institutions, and products is more efficient and effective

[5]For example, see GAO, *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007); and *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004). See Related GAO Products appendix for additional reports.

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than leaving the fairness and integrity of these activities to be ensured solely by market participants themselves.

The federal laws related to financial regulation set forth specific authorities and responsibilities for regulators, although these authorities typically do not contain provisions explicitly linking such responsibilities to overall goals of financial regulation. Nevertheless, financial regulation generally has sought to achieve four broad goals:

- *Ensure adequate consumer protections.* Because financial institutions' incentives to maximize profits can in some cases lead to sales of unsuitable or fraudulent financial products, or unfair or deceptive acts or practices, U.S. regulators take steps to address informational disadvantages that consumers and investors may face, ensure consumers and investors have sufficient information to make appropriate decisions, and oversee business conduct and sales practices to prevent fraud and abuse.
- *Ensure the integrity and fairness of markets.* Because some market participants could seek to manipulate markets to obtain unfair gains in a way that is not easily detectable by other participants, U.S. regulators set rules for and monitor markets and their participants to prevent fraud and manipulation, limit problems in asset pricing, and ensure efficient market activity.
- *Monitor the safety and soundness of institutions.* Because markets sometimes lead financial institutions to take on excessive risks that can have significant negative impacts on consumers, investors, and taxpayers, regulators oversee risk-taking activities to promote the safety and soundness of financial institutions.
- *Act to ensure the stability of the overall financial system.* Because shocks to the system or the actions of financial institutions can lead to instability in the broader financial system, regulators act to reduce systemic risk in various ways, such as by providing emergency funding to troubled financial institutions.

Although these goals have traditionally been their primary focus, financial regulators are also often tasked with achieving other goals as they carry out their activities. These can include promoting economic growth, capital formation, and competition in our financial markets. Regulators have also taken actions with an eye toward ensuring the competitiveness of regulated U.S. financial institutions with those in other sectors or with others around the world. In other cases, financial institutions may be

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required by law or regulation to foster social policy objectives such as fair access to credit and increased home ownership.

In general, these goals are reflected in statutes, regulations, and administrative actions, such as rulemakings or guidance, by financial institution supervisors. Laws and regulatory agency policies can set a greater priority on some roles and missions than others. Regulators are usually responsible for multiple regulatory goals and often prioritize them differently. For example, state and federal bank regulators generally focus on the safety and soundness of depository institutions; federal securities and futures regulators focus on the integrity of markets, and the adequacy of information provided to investors; and state securities regulators primarily address consumer protection. State insurance regulators focus on the ability of insurance firms to meet their commitments to the insured.

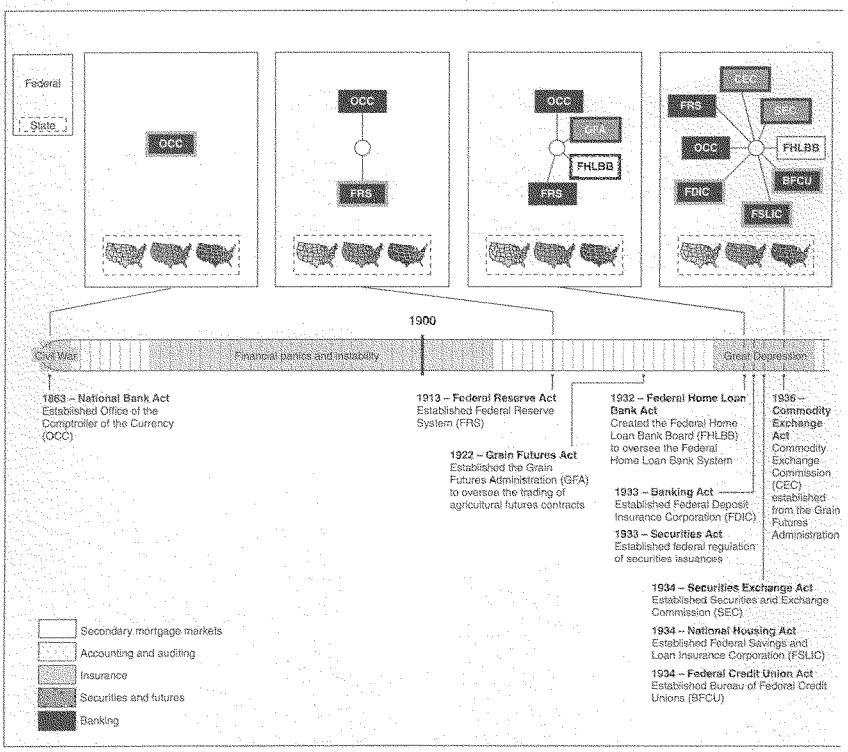
The degrees to which regulators oversee institutions, markets, or products also vary depending upon, among other things, the regulatory approach Congress has fashioned for different sectors of the financial industry. For example, some institutions, such as banks, are subject to comprehensive regulation to ensure their safety and soundness. Among other things, they are subject to examinations and limitations on the types of activities they may conduct. Other institutions conducting financial activities are less regulated, such as by only having to register with regulators or by having less extensive disclosure requirements. Moreover, some markets, such as those for many over-the-counter derivatives markets, as well as activities within those markets, are not subject to oversight regulation at all.

Today's Financial Regulatory System Was Built over More Than a Century, Largely in Response to Crises or Market Developments

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. (See fig. 1.) Our regulatory system has multiple financial regulatory bodies, including five federal and multiple state agencies that oversee depository institutions. Securities activities are overseen by federal and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by a federal regulator and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little federal involvement.

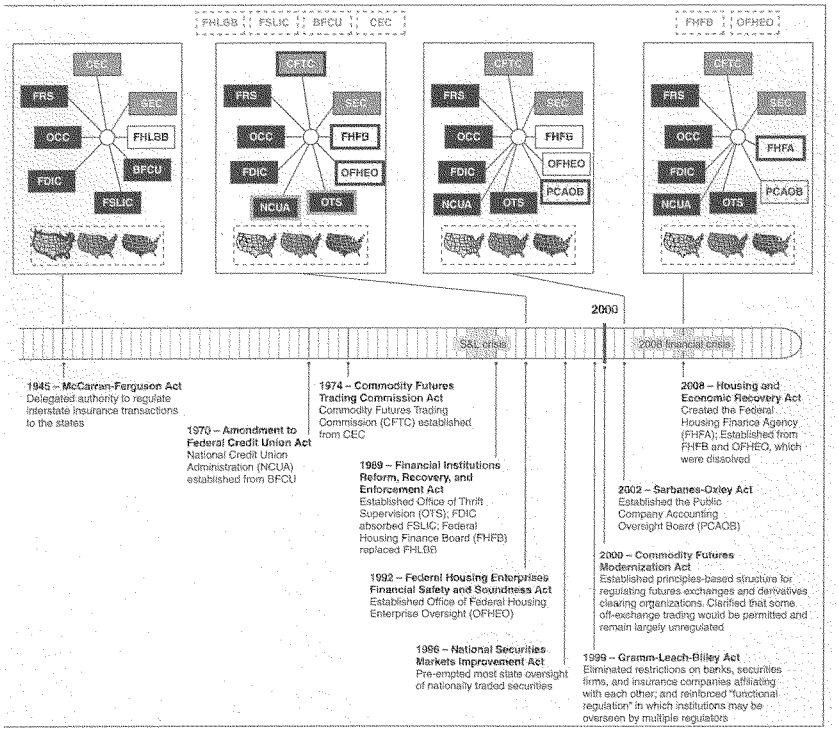
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Figure 1: Formation of U.S. Financial Regulatory System (1863-2008)



Source: GAO.

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PCAOB
FHFA
2000
S&L crisis
2008 financial crisis
1945 – McCarran-Ferguson Act
Delegated authority to regulate interstate insurance transactions to the states
1970 – Amendment to Federal Credit Union Act
National Credit Union Administration (NCUA) established from BFCU
1974 – Commodity Futures Trading Commission Act
Commodity Futures Trading Commission (CFTC) established from CEC
1989 – Financial Institutions Reform, Recovery, and Enforcement Act
Established Office of Thrift Supervision (OTS); FDIC absorbed FSLIC; Federal Housing Finance Board (FHFB) replaced FHLBB
1992 – Federal Housing Enterprises Financial Safety and Soundness Act
Established Office of Federal Housing Enterprise Oversight (OFHEO)
1996 – National Securities Markets Improvement Act
Pre-empted most state oversight of nationally traded securities
1999 – Gramm-Leach-Bliley Act
Eliminated restrictions on banks, securities firms, and insurance companies affiliating with each other; and reinforced "functional regulation" in which institutions may be overseen by multiple regulators
2002 – Sarbanes-Oxley Act
Established the Public Company Accounting Oversight Board (PCAOB)
2008 – Commodity Futures Modernization Act
Established principles-based structure for regulating futures exchanges and derivatives clearing organizations. Clarified that some off-exchange trading would be permitted and remain largely unregulated
2008 – Housing and Economic Recovery Act
Created the Federal Housing Finance Agency (FHFA); Established from FHFB and OFHEO, which were dissolved

Overall, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations (SRO), and hundreds of state financial regulatory agencies. The following sections

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describe how regulation evolved in various sectors, including banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets, and other financial institutions. The accounting and auditing environment for financial institutions, and the role of the Gramm-Leach-Bliley Act in financial regulation, are also discussed.

Banking

Since the early days of our nation, banks have allowed citizens to store their savings and used these funds to make loans to spur business development. Until the middle of the 1800s, banks were chartered by states and state regulators supervised their activities, which primarily consisted of taking deposits and issuing currency. However, the existence of multiple currencies issued by different banks, some of which were more highly valued than others, created difficulties for the smooth functioning of economic activity. In an effort to finance the nation's Civil War debt and reduce financial uncertainty, Congress passed the National Bank Act of 1863, which provided for issuance of a single national currency. This act also created the Office of the Comptroller of the Currency (OCC), which was to oversee the national currency and improve banking system efficiency by granting banks national charters to operate and conducting oversight to ensure the sound operations of these banks. As of 2007, of the more than 16,000 depository institutions subject to federal regulation in the United States, OCC was responsible for chartering, regulating, and supervising nearly 1,700 commercial banks with national charters.

In the years surrounding 1900, the United States experienced troubled economic conditions and several financial panics, including various instances of bank runs as depositors attempted to withdraw their funds from banks whose financial conditions had deteriorated. To improve the liquidity of the U.S. banking sector and reduce the potential for such panics and runs, Congress passed the Federal Reserve Act of 1913. This act created the Federal Reserve System, which consists of the Board of Governors of the Federal Reserve System (Federal Reserve), and 12 Federal Reserve Banks, which are congressionally chartered semiprivate entities that undertake a range of actions on behalf of the Federal Reserve, including supervision of banks and bank holding companies, and lending to troubled banks. The Federal Reserve was given responsibility to act as the federal supervisory agency for state-chartered banks—banks authorized to do business under charters issued by states—that are members of the Federal Reserve System.[6] In addition to supervising and

[6]Staff at the Federal Reserve Banks act as supervisors in conjunction with the Board.

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regulating bank and financial holding companies and nearly 900 state-chartered banks, the Federal Reserve also develops and implements national monetary policy, and provides financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.

Several significant changes to the U.S. financial regulatory system again were made as a result of the turbulent economic conditions in the late 1920s and 1930s. In response to numerous bank failures resulting in the severe contraction of economic activity of the Great Depression, the Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC), which administers a federal program to insure the deposits of participating banks. Subsequently, FDIC's deposit insurance authority expanded to include thrifts.[7] Additionally, FDIC provides primary federal oversight of any insured state-chartered banks that are not members of the Federal Reserve System, and it serves as the primary federal regulator for over 5,200 state-chartered institutions. Finally, FDIC has backup examination and enforcement authority over all of the institutions it insures in order to mitigate losses to the deposit insurance funds.

Securities

Prior to the 1930s, securities markets were overseen by various state securities regulatory bodies and the securities exchanges themselves. In the aftermath of the stock market crash of 1929, the Securities Exchange Act of 1934 created a new federal agency, the Securities and Exchange Commission (SEC) and gave it authority to register and oversee securities broker-dealers, as well as securities exchanges, to strengthen securities oversight and address inconsistent state securities rules.[8] In addition to regulation by SEC and state agencies, securities markets and the broker-dealers that accept and execute customer orders in these markets

[7]Thrifts, also known as savings and loans, are financial institutions that accept deposits and make loans, particularly for home mortgages. Until 1989, thrift deposits were federally insured by the Federal Savings and Loan Insurance Corporation (FSLIC), which was created by the National Housing Act of 1934. After experiencing solvency problems in connection with the savings and loan crisis of the 1980s, FSLIC was abolished and its insurance function was transferred to FDIC.

[8]The Securities Act of 1933 (1933 Act), 48 Stat. 74. et. seq., assigned federal supervision of securities to the Federal Trade Commission (FTC) by, among other things, requiring that securities offerings subject to the act's registration requirements be registered with the FTC. See 1933 Act, §§ 2, 5, 6 (May 27, 1933). In the 1934 act, Congress replaced the FTC's role by transferring its powers, duties, and functions under the 1933 act to SEC. See Securities Exchange Act of 1934, 48 Stat. 881, §§ 3(a), 210 (June 6, 1934).

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continue to be regulated by SROs, including those of the exchanges and the Financial Industry Regulatory Authority, that are funded by the participants in the industry. Among other things, these SROs establish rules and conduct examinations related to market integrity and investor protection. SEC also registers and oversees investment companies and advisers, approves rules for the industry, and conducts examinations of broker-dealers and mutual funds. State securities regulators—represented by the North American Securities Administrators Association—are generally responsible for registering certain securities products and, along with SEC, investigating securities fraud.[9] SEC is also responsible for overseeing the financial reporting and disclosures that companies issuing securities must make under U.S. securities laws. SEC was also authorized to issue and oversee U.S. accounting standards for entities subject to its jurisdiction, but has delegated the creation of accounting standards to a private-sector organization, the Financial Accounting Standards Board, which establishes generally accepted accounting principles.

Thrifts and Credit Unions

The economic turmoil of the 1930s also prompted the creation of federal regulators for other types of depository institutions, including thrifts and credit unions.[10] These institutions previously had been subject to oversight only by state authorities. However, the Home Owners' Loan Act of 1933 empowered the newly created Federal Home Loan Bank Board to charter and regulate federal thrifts, and the Federal Credit Union Act of 1934 created the Bureau of Federal Credit Unions to charter and supervise credit unions.[11] Congress amended the Federal Credit Union Act in 1970 to

[9]The National Securities Markets Improvement Act, Pub. L. No. 104-290 (Oct. 11, 1996), preempted state securities registration requirements for all but a subset of small securities products and limited state supervision of broker-dealers, but left intact the right of states to investigate securities fraud.

[10]Credit unions are member-owned financial institutions that generally offer their members services similar to those provided by banks.

[11]Home Owners' Loan Act of 1933, 48 Stat. 128 (June 13, 1933). The administration of the Federal Credit Union Act was originally vested in the Farm Credit Administration (Act of June 26, 1934, 48 Stat. 1216.) Executive Order No. 9148, dated April 27, 1942 (7 F.R. 3145), transferred the functions, powers and duties of the Farm Credit Administration to FDIC. Effective July 29, 1948, the powers, duties and functions transferred to FDIC were transferred to the Federal Security Agency. (Act of June 29, 1948, 62 Stat. 1091.) Reorganization Plan No. 1 of 1953, effective April 11, 1953, abolished the Federal Security Agency and transferred the Bureau of Federal Credit Unions, together with other agencies of the Federal Security Agency, to the Department of Health, Education, and Welfare. (67 Stat. 631, 18 F.R. 2053.).

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establish the National Credit Union Administration (NCUA), which is responsible for chartering and supervising over 5,000 federally chartered credit unions, as well as insuring deposits in these and more than 3,000 state-chartered credit unions.[12] Oversight of these state-chartered credit unions is managed by 47 state regulatory agencies, represented by the National Association of State Credit Union Supervisors.[13]

From 1980 to 1990, over 1,000 thrifts failed at a cost of about $100 billion to the federal deposit insurance funds. In response, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Home Loan Bank Board and, among other things, established the Office of Thrift Supervision (OTS) to improve thrift oversight.[14] OTS charters about 750 federal thrifts and oversees these and about 70 state-chartered thrifts, as well as savings and loan holding companies.[15]

Futures

Oversight of the trading of futures contracts, which allow their purchasers to buy or sell a specific quantity of a commodity for delivery in the future, has also changed over the years in response to changes in the marketplace. Under the Grain Futures Act of 1922, the trading of futures contracts was overseen by the Grain Futures Administration, an office within the Department of Agriculture, reflecting the nature of the products for which futures contracts were traded.[16] However, futures contracts were later created for nonagricultural commodities, such as energy products like oil and natural gas, metals such as gold and silver, and financial products such as Treasury bonds and foreign currencies. In 1974,

[12]Public Law 91–206 (Mar. 10, 1970, 84 Stat. 49) created the National Credit Union Administration as an independent agency and transferred all of the functions of the Bureau of Federal Credit Unions to the new administration.

[13]Federally insured state credit unions also are subject to supervision by NCUA.

[14]Pub. L. No. 101-73 § 301 (Aug. 9, 1989).

[15]The five federal depository institution regulators discussed earlier coordinate formally through the Federal Financial Institutions Examination Council, an interagency body that was established in 1979 and is empowered to (1) prescribe uniform principles, standards, and report forms for the federal examination of financial institutions; and (2) make recommendations to promote uniformity in the supervision of financial institutions.

[16]The Grain Futures Act (ch. 369, 42 Stat. 998, Sept. 21, 1922). In 1936 the act was renamed the "Commodity Exchange Act (CEA)," which, among other things, created the Commodity Exchange Commission (CEC), a predecessor agency to the Commodity Futures Trading Commission. 49 Stat. 1491 (June 15, 1936).

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a new independent federal agency, the Commodity Futures Trading Commission (CFTC), was created to oversee the trading of futures contracts.[17] Like SEC, CFTC relies on SROs, including the futures exchanges and the National Futures Association, to establish and enforce rules governing member behavior. In 2000, the Commodity Futures Modernization Act of 2000 established a principles-based structure for the regulation of futures exchanges and derivatives clearing organizations, and clarified that some off-exchange derivatives trading—and in particular trading on facilities only accessible to large, sophisticated traders—was permitted and would be largely unregulated or exempt from regulation.[18]

Insurance

Unlike most other financial services, insurance activities traditionally have been regulated at the state level. In 1944, a U.S. Supreme Court decision determined that the insurance industry was subject to interstate commerce laws, which could then have allowed for federal regulation, but Congress passed the McCarran-Ferguson Act in 1945 to explicitly return insurance regulation to the states.[19] As a result, as many as 55 state, territorial, or other local jurisdiction authorities oversee insurance activities in the United States, although state regulations and other activities are often coordinated nationally by the National Association of Insurance Commissioners (NAIC).[20]

[17]Commodity Futures Trading Commission Act, Pub. L. No. 93-463 (Oct. 23, 1974).

[18]A derivative is a financial instrument representing a right or obligation based on the value at a particular time of an underlying asset, reference rate, or index, such as a stock, bond, agricultural or other physical commodity, interest rate, currency exchange rate, or stock index. Derivatives contracts are used by firms around the world to manage market risk—the exposure to the possibility of financial loss caused by adverse changes in the values of assets or liabilities—by transferring it from entities less willing or able to manage it to those more willing and able to do so. Common types of derivatives include futures, options, forwards, and swaps and can be traded through an exchange, known as exchange-traded, or privately, known as over-the counter.

[19]Up until 1944, insurance was not considered interstate commerce and, therefore, was not subject to federal regulation. In *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944) the Supreme Court held that Congress could regulate insurance transactions that truly are interstate. Congress subsequently enacted the McCarran-Ferguson Act (Mar. 9, 1945), ch. 20, 59 Stat. 33, which provides that state laws apply to insurance unless they are specifically pre-empted by Congress. See 15 U.S.C. § 1011.

[20]NAIC is made up of the heads of the insurance departments of 50 states, the District of Columbia, and U.S. territories to provide a forum for the development of uniform policy when uniformity is appropriate.

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Secondary Mortgage Markets

The recent financial crisis in the credit and housing markets has prompted the creation of a new, unified federal financial regulatory oversight agency, the Federal Housing Finance Agency (FHFA), to oversee the government-sponsored enterprises (GSE) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.[21] Fannie Mae and Freddie Mac are private, federally chartered companies created by Congress to, among other things, provide liquidity to home mortgage markets by purchasing mortgage loans, thus enabling lenders to make additional loans. The system of 12 Federal Home Loan Banks provides funding to support housing finance and economic development.[22] Until enactment of the Housing and Economic Recovery Act of 2008, Fannie Mae and Freddie Mac had been overseen since 1992 by the Office of Federal Housing Enterprise Oversight (OFHEO), an agency within the Department of Housing and Urban Development, and the Federal Home Loan Banks were subject to supervision by the Federal Housing Finance Board (FHFB), an independent regulatory agency.[23] OFHEO regulated Fannie Mae and Freddie Mac on matters of safety and soundness, while HUD regulated their mission-related activities. FHFB served as the safety and soundness and mission regulator of the Federal Home Loan Banks. In July 2008, the Housing and Economic Recovery Act of 2008 created FHFA to establish more effective and more consistent oversight of the three housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. With respect to Fannie Mae and Freddie Mac, the law gives FHFA such new regulatory authorities as the power to regulate the retained mortgage portfolios, to set more stringent capital standards, and to place a failing entity in receivership. In addition, the law provides FHFA with funding outside the annual appropriations process. The law also combined the regulatory authorities for all the housing GSEs that were previously distributed

[21]Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, title I, subtitle A (July 30, 2008).

[22]The 12 Federal Home Loan Banks form a system of regional cooperatives, each with its own president and board of directors, located in different regions of the country. Their statutory mission is to provide cost-effective funding to members for use in housing, community, and economic development; to provide regional affordable housing programs, which create housing opportunities for low- and moderate-income families; to support housing finance through advances and mortgage programs; and to serve as a reliable source of liquidity for its membership.

[23]OFHEO was created in title XIII of the Housing and Community Development Act (1992), Pub. L. No. 102-550 (Oct. 28, 1992). In 1932, the Federal Home Loan Bank Act created the Federal Home Loan Bank System to provide liquidity to thrifts to make home mortgages. Oversight of these responsibilities was later transferred to the Federal Housing Finance Board.

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among OFHEO, FHFB, and the Department of Housing and Urban Development. In September 2008, Fannie Mae and Freddie Mac were placed in conservatorship, with FHFA serving as the conservator under powers provided in the 2008 act. Treasury also created a backstop lending facility for the Federal Home Loan Banks, should they decide to use it. In November 2008, the Federal Reserve announced plans to purchase mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac on the open market.

Gramm-Leach-Bliley

Changes in the types of financial activities permitted for depository institutions and their affiliates have also shaped the financial regulatory system over time. Under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services. However, in the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities and, in addition, provided a regulatory process allowing for the approval of new types of financial activity.[24] Under GLBA, qualifying financial institutions are permitted to engage in banking, securities, insurance, and other financial activities. When these activities are conducted within the same bank holding company structure, they remain subject to regulation by "functional regulators," which are the federal authorities having jurisdiction over specific financial products or services, such as SEC or CFTC. As a result, multiple regulators now oversee different business lines within a single institution. For example, broker-dealer activities are generally regulated by SEC even if they are conducted within a large financial conglomerate that is subject to the Bank Holding Company Act, which is administered by the Federal Reserve. The functional regulator approach was intended to provide consistency in regulation, focus regulatory restrictions on the relevant functional area, and avoid the potential need for regulatory agencies to develop expertise in all aspects of financial regulation.

[24]Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (Nov. 12, 1999). Although originally precluded from conducting significant securities underwriting activities, bank holding companies were permitted to conduct more of such activities over the years. For example, in 1987, the Federal Reserve allowed the subsidiaries of bank holding companies to engage in securities underwriting activities up to 5 percent of their revenue. Over time, the Federal Reserve also expanded the types of securities that banks could conduct business in and raised the revenue limit to 10 percent in 1989 and to 25 percent in 1996.

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Accounting and Auditing

In addition to the creation of various regulators over time, the accounting and auditing environment for financial institutions and market participants—a key component of financial oversight—has also seen substantial change. In the early 2000s, various companies with publicly traded securities were found to have issued materially misleading financial statements. These companies included Enron and WorldCom, both of which filed for bankruptcy. When the actual financial conditions of these companies became known, their auditors were called into question, and one of the largest, Arthur Andersen, was dissolved after the Department of Justice filed criminal charges related to its audits of Enron. As a result of these and other corporate financial reporting and auditing scandals, the Sarbanes-Oxley Act of 2002 was enacted.[25] Among other things, Sarbanes-Oxley expanded public company reporting and disclosure requirements and established new ethical and corporate responsibility requirements for public company executives, boards of directors, and independent auditors. The act also created a new independent public company audit regulator, the Public Company Accounting Oversight Board, to oversee the activities of public accounting firms. The activities of this board are, in turn, overseen by SEC.

Other Financial Institutions

Some entities that provide financial services are not regulated by any of the existing federal financial regulatory bodies. For example, entities such as mortgage brokers, automobile finance companies, and payday lenders that are not bank subsidiaries or affiliates primarily are subject to state oversight, with the Federal Trade Commission acting as the primary federal agency responsible for enforcing their compliance with federal consumer protection laws.

[25]Pub. L. No. 107-204 (July 30, 2002).

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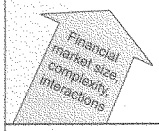
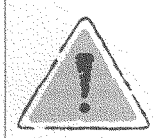
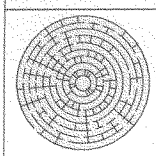
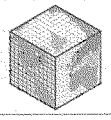
Changes in Financial Institutions and Their Products Have Significantly Challenged the U.S. Financial Regulatory System

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 2.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulating these large conglomerates has proven challenging, particularly in overseeing their risk management activities on a consolidated basis and in identifying and mitigating the systemic risks they pose. A second development has been the emergence of large and sometimes less-regulated market participants, such as hedge funds and credit rating agencies, which now play key roles in our financial markets. Third, the development of new and complex products and services has challenged regulators' abilities to ensure that institutions are adequately identifying and acting to mitigate risks arising from these new activities and that investors and consumers are adequately informed of the risks. In light of these developments, ensuring that U.S. accounting standards have kept pace has also proved difficult, and the impending transition to conform to international accounting standards is likely to create additional challenges.[26] Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

[26]We include discussion of audit and accounting standards in this report because any new effort to examine the structure of financial regulation in the United States could include consideration of the process for creating and adopting these standards. However, determining whether the oversight of this process should be changed was not part of the scope of this report.

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Figure 2: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System

Developments in financial markets and products	Examples of how developments have challenged the regulatory system
 **Emergence of large, complex, globally active, interconnected financial conglomerates**	Regulators sometimes lack sufficient authority, tools, or capabilities to oversee and mitigate risks.
	Identifying, preventing, mitigating, and resolving systemic crises has become more difficult.
 **Less-regulated entities have come to play increasingly critical roles in financial system**	Nonbank lenders and a new private-label securitization market played significant roles in the subprime mortgage crisis that led to broader market turmoil.
	Activities of hedge funds have posed systemic risks.
	Overreliance on credit ratings of mortgage-backed products contributed to the recent turmoil in financial markets.
	Financial institutions' use of off-balance sheet entities led to ineffective risk disclosure and exacerbated recent market instability.
 **New and complex products that pose challenges to financial stability and investor and consumer understanding of risks.**	Complex structured finance products have made it difficult for institutions and their regulators to manage associated risks.
	Growth in complex and less-regulated over-the-counter derivatives markets have created systemic risks and revealed market infrastructure weaknesses.
	Investors have faced difficulty understanding complex investment products, either because they failed to seek out necessary information or were misled by improper sales practices.
	Consumers have faced difficulty understanding mortgages and credit cards with new and increasingly complicated features, due in part to limitations in consumer disclosures and financial literacy efforts.
	Accounting and auditing entities have faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.
 **Financial markets have become increasingly global in nature, and regulators have had to coordinate their efforts internationally.**	Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards.
	Fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators, such as negotiations on Basel II and certain insurance matters.

Sources: GAO (analysis); Art Explosion (images).

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Conglomeration and Increased Interconnectedness in Financial Markets Have Created Difficulties for a Regulatory System That Lacks a Systemwide Focus

Overseeing large financial conglomerates that have emerged in recent decades has proven challenging, particularly in regulating their consolidated risk management practices and in identifying and mitigating the systemic risks they pose. These systemically important institutions in many cases have tens of thousands or more customers and extensive financial linkages with each other through loans, derivatives contracts, or trading positions with other financial institutions or businesses. The activities of these large financial institutions, as we have seen by recent events, can pose significant systemic risks to other market participants and the economy as a whole, but the regulatory system was not prepared to adequately anticipate and prevent such risks.

Largely as the result of waves of mergers and consolidations, the number of financial institutions today has declined. However, the remaining institutions are generally larger and more complex, provide more and varied services, offer similar products, and operate in increasingly global markets. Among the most significant of these changes has been the emergence and growth of large financial conglomerates or universal banks that offer a wide range of products that cut across the traditional financial sectors of banking, securities, and insurance. A 2003 IMF study highlighted this emerging trend. Based on a worldwide sample of the top 500 financial services firms in assets, the study found that the percentage of the largest financial institutions in the United States that are conglomerates—financial institutions having substantial operations in more than one of the sectors (banking, securities, and insurance)—increased from 42 percent of the U.S. financial institutions in the sample in 1995 to 62 percent in 2000.[27] This new environment contrasts with that of the past in which banks primarily conducted traditional banking activities such as deposit taking and lending; securities broker-dealers were largely focused on brokerage and underwriting activities; and insurance firms offered a more limited set of insurance products. In a report that analyzed the regulatory structures of various countries, The Group of Thirty noted that the last 25 years have been a period of enormous transformation in the financial services sector, with a marked shift from firms engaging in distinct banking, securities, and insurance businesses to one in which more integrated financial services conglomerates offer a broad range of financial products across the globe. These fundamental changes in the nature of the financial service markets

[27]Gianni De Nicoló, Philip Bartholomew, Jahanara Zaman, and Mary Zephirin, "Bank Consolidation, Internationalization, and Conglomeration: Trends and Implications for Financial Risk" (IMF Working Paper 03/158, Washington, D.C., July 2003).

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around the world have exposed the shortcomings of financial regulatory models, some of which have not been adapted to the changes in business structures.[28]

While posing challenges to regulators, these changes have resulted in some benefits in the United States financial services industry. For example, the ability of financial institutions to offer products of varying types increased the options available to consumers for investing their savings and preparing for their retirement. Conglomeration has also made it more convenient for consumers to conduct their financial activities by providing opportunities for one-stop shopping for most or all of their needs, and by promoting the cross-selling of new innovative products of which consumers may otherwise not have been aware.

However, the rise of large financial conglomerates has also posed risks that our current financial regulatory system does not directly address. First, although the activities of these large interconnected financial institutions often cross traditional sector boundaries, financial regulators under the current U.S. regulatory system did not always have full authority or sufficient tools and capabilities to adequately oversee the risks that these financial institutions posed to themselves and other institutions. As we noted in a 2007 report, the activities of the Federal Reserve, SEC, and OTS to conduct consolidated supervision of many of the largest U.S. financial institutions were not as efficient and effective as needed because these agencies were not collaborating more systematically.[29] In addition, the recent market crisis has revealed significant problems with certain aspects of these regulators' oversight of financial conglomerates. For example, some of the top investment banks were subject to voluntary and limited oversight at the holding-company level—the level of the institution that generally managed its overall risks—as part of SEC's Consolidated Supervised Entity (CSE) Program. SEC's program was created in 2004 as a way for global investment bank conglomerates that lack a supervisor

[28]Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (Washington, D.C., 2008). The Group of Thirty, established in 1978, is a private, nonprofit, international body—composed of very senior representatives of the private and public sectors and academia—that consults and publishes papers on international economic and monetary affairs.

[29]GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007).

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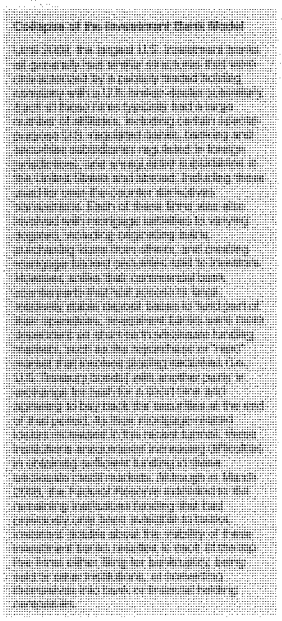
under law to voluntarily submit to regulation.[30] This supervision, which could include SEC examinations of the parent companies' and affiliates' operations and monitoring of their capital levels, enabled the CSEs to qualify for alternative capital rules in exchange for consenting to supervision at the holding company level. Being subject to consolidated supervision was perceived as necessary for these financial institutions to continue operating in Europe under changes implemented by the European Union in 2005.[31]

However, according to a September 2008 report by SEC's Inspector General, this supervisory program failed to effectively oversee these institutions for several reasons, including the lack of an effective mechanism for ensuring that these entities maintained sufficient capital. In comparison to commercial bank conglomerates, these investment banks were holding much less capital in relation to the activities exposing them to financial risk. For example, at the end of 2007, the five largest investment banks had assets to equity capital leverage ratios of between 26 and 34 to 1—meaning that for every dollar of capital capable of absorbing losses, these institutions held between $26 and $34 of assets subject to loss. In contrast, the largest commercial bank conglomerates, which were subject to different regulatory capital requirements, tended to be significantly less leveraged, with the average leverage ratio of the top five largest U.S. bank conglomerates at the end of 2007 only about 13 to 1. Moreover, because the program SEC used to oversee these investment bank conglomerates was voluntary, it had no authority to compel these institutions to address any problems that may have been identified. Instead, SEC's only means for coercing an institution to take corrective actions was to disqualify an institution from CSE status. SEC also lacked the ability to provide emergency funding for these investment bank conglomerates in a similar way that the Federal Reserve could for commercial banks. As a result, these CSE firms, whose activities resulted in their being significant and systemically important participants with vast interconnections with other financial institutions, were more vulnerable to market disruptions that could create risks to the overall financial system,

[30]Under the CSE program, which SEC initiated pursuant to its capitalization requirements for broker-dealers, SEC instituted a system for supervising large broker-dealers at the holding company level. See 69 *Fed. Reg.* 34428 (June 21, 2004). Previously, SEC had focused its broker-dealer net capital regulations only upon the firms themselves, not their holding companies or other subsidiaries.

[31]69 *Fed. Reg.* 34428 at n. 9.

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but not all were subject to full and consistent oversight by a supervisor with adequate authority and resources. For example, one of the ways that the bankruptcy filing of Lehman Brothers affected other institutions was that 25 money market fund advisers had to act to protect their investors against losses arising from their investments in that company's debt, with at least one of these funds having to be liquidated and distributed to its investors.

Following the sale of Bear Stearns to JPMorgan Chase, the Lehman bankruptcy filing, and the sale of Merrill Lynch to Bank of America, the remaining CSEs opted to become bank holding companies subject to Federal Reserve oversight. SEC suspended its CSE program and the Chairman stated that "the last six months have made it abundantly clear that voluntary regulation does not work."[32]

Recent events have also highlighted difficulties faced by the Federal Reserve and OTS in their roles in overseeing risk management at large financial and thrift holding companies, respectively. In June 2008 testimony, a Federal Reserve official acknowledged such supervisory lessons, noting that under the current U.S. regulatory structure consisting of multiple supervisory agencies, challenges can arise in assessing risk profiles of large, complex financial institutions operating across financial sectors, particularly given the growth in the use of sophisticated financial products that can generate risks across various legal entities. He also noted that recent events have highlighted the importance of enterprisewide risk management, noting that supervisors need to understand risks across a consolidated entity and assess the risk management tools being applied across the financial institution.[33] Our own work had raised concerns over the adequacy of supervision of these large financial conglomerates. For example, one of the large entities that OTS oversaw was the insurance conglomerate AIG, which was subject to a government takeover necessitated by financial difficulties the firm experienced as the result of OTC derivatives activities related to mortgages. In a 2007 report, we expressed concerns over the appropriateness of having OTS oversee diverse global financial institutions

[32]SEC Press Release (2008-230), *Chairman Cox Announces End of Consolidated Supervised Entities Program* (Sept. 26, 2008).

[33]Senate Committee on Banking, Housing, and Urban Affairs, *Condition of the Banking System*, 110th Cong., 2nd sess., June 5, 2008 (testimony of Federal Reserve Vice Chairman Donald L. Kohn).

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given the size of the agency relative to the institutions for which it was responsible.[34] We had also noted that although OTS oversaw a number of holding companies that are primarily in the insurance business, including AIG, it had only one specialist in this area as of March 2007.[35] An OTS official noted, however, that functional regulation established by Gramm-Leach-Bliley avoided the need for regulatory agencies to develop expertise in all aspects of financial regulation.

Second, the emergence of these large institutions with financial obligations with thousands of other entities has revealed that the existing U.S. regulatory system is not well-equipped for identifying and addressing risks across the financial system as a whole. In the current environment, with multiple regulators primarily responsible for just individual institutions or markets, no one regulator is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. For example, multiple factors contributed to the subprime mortgage crisis, and many market participants played a role in these events, including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others. The collective activities of these entities, rather than one particular institution, likely all contributed to the overall market collapse. In particular, the securitization process created incentives throughout the chain of participants to emphasize loan volume over loan quality, which likely contributed to the problem as lenders sold loans on the secondary market, passing risks on to investors. Similarly, once financial institutions began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events. Ad hoc actions by the Department of the Treasury, the Federal Reserve, other members of the President's Working Group on Financial Markets, and FDIC were aimed at helping to mitigate the fallout once events began to unfold.[36] However, even given this ad hoc coordination, our past work has repeatedly identified limitations of the current U.S. federal regulatory structure to adequately coordinate and share information to monitor risks across markets or "functional" areas to

[34]GAO-07-154.

[35]AIG is subject to OTS supervision as a savings and loan holding company because of its control of a thrift. See, e.g., 12 U.S.C. § 1467a(a)(1)(D), (H).

[36]The President's Working Group on Financial Markets consists of the Secretary of the Treasury, and the Chairmen of the Federal Reserve, SEC, and CFTC.

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identify potential systemic crises.[37] Whether a greater focus on systemwide risks would have fully prevented the recent financial crises is unclear, but it is reasonable to conclude that such a mechanism would have had better prospects of identifying the breadth of the problem earlier and been better positioned to stem or soften the extent of the market fallout.

Existing Regulatory System Failed to Adequately Address Problems Associated with Less-Regulated Entities That Played Significant Roles in the U.S. Financial System

A second dramatic development in U.S. financial markets in recent decades has been the increasingly critical roles played by less-regulated entities. In the past, consumers of financial products generally dealt with entities such as banks, broker-dealers, and insurance companies that were regulated by a federal or state regulator. However, in the last few decades, various entities—nonbank lenders, hedge funds, credit rating agencies, and special-purpose investment entities—that are not always subject to full regulation by such authorities have become important participants in our financial services markets. These unregulated or less-regulated entities can provide substantial benefits by supplying information or allowing financial institutions to better meet demands of consumers, investors or shareholders but pose challenges to regulators that do not fully or cannot oversee their activities.

Activities of Nonbank Mortgage Lenders Played a Significant Role in Mortgage Crisis but Were Not Adequately Addressed by Existing Regulatory System

The role of nonbank mortgage lenders in the recent financial collapse provides an example of a gap in our financial regulatory system resulting from activities of institutions that were generally subject to little or no direct oversight by federal regulators.[38] The significant participation by these nonbank lenders in the subprime mortgage market—which targeted products with riskier features to borrowers with limited or poor credit history—contributed to a dramatic loosening in underwriting standards leading up to the crisis. In recent years, nonbank lenders came to represent a large share of the consumer lending market, including for subprime mortgages. Specifically, as shown in figure 3, of the top 25 originators of subprime and other nonprime loans in 2006 (which accounted for more than 90 percent of the dollar volume of all such

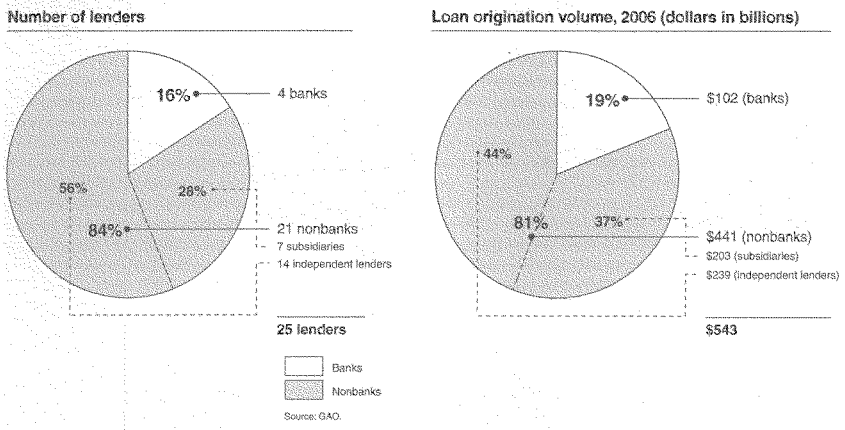
[37]We have noted limitations on effectively planning strategies that cut across regulatory agencies. See GAO-05-61.

[38]For the purposes of this report, nonbank lenders are those that are not banks, thrifts, or credit unions. Such entities include independent mortgage lenders, subsidiaries of national banks, subsidiaries of thrifts, and nonbank mortgage lending subsidiaries of holding companies. Although we include operating subsidiaries of national banks in the category of nonbanks, they are subject to the same federal requirements and OCC supervision and examination as their parent bank, according to an OCC official.

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originations), all but 4 were nonbank lenders, accounting for 81 percent of origination by dollar volume.[39]

Figure 3: Status of Top 25 Subprime and Nonprime Mortgage Lenders (2006)



Source: GAO.

Although these lenders were subject to certain federal consumer protection and fair lending laws, they were generally not subject to the same routine monitoring and oversight by federal agencies that their bank counterparts were. From 2003 to 2006, subprime lending grew from about 9 percent to 24 percent of mortgage originations (excluding home equity loans), and Alt-A lending (nonprime loans considered less risky than subprime) grew from about 2 percent to almost 16 percent, according to data from the trade publication *Inside Mortgage Finance*. The resulting sharp rise in defaults and foreclosures that occurred as subprime and other homeowners were unable to make mortgage payments led to the collapse of the subprime mortgage market and set off a series of events that led to today's financial turmoil.

[39]Of the 21 nonbank lenders, 7 were subsidiaries of national banks, thrifts, or holding companies.

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In previous reports, we noted concerns that existed about some of these less-regulated nonbank lenders and recommended that federal regulators actively monitor their activities.[40] For example, in a 2004 report, we reported that some of these nonbank lenders had been the targets of notable federal and state enforcement actions involving abusive lending. As a result, we recommended to Congress that the Federal Reserve should be given a greater role in monitoring the activities of some nonbank mortgage lenders that are subsidiaries of bank holding companies that the Federal Reserve regulates. Only recently, in the wake of the subprime mortgage crisis, the Federal Reserve began a pilot program in conjunction with OTS and the Conference of State Bank Supervisors to monitor the activities of nonbank subsidiaries of holding companies, with the states conducting examinations of independent state-licensed lenders. Nevertheless, other nonbank lenders continue to operate under less rigorous federal oversight and remain an example of the risks posed by less-regulated institutions in our financial regulatory system.

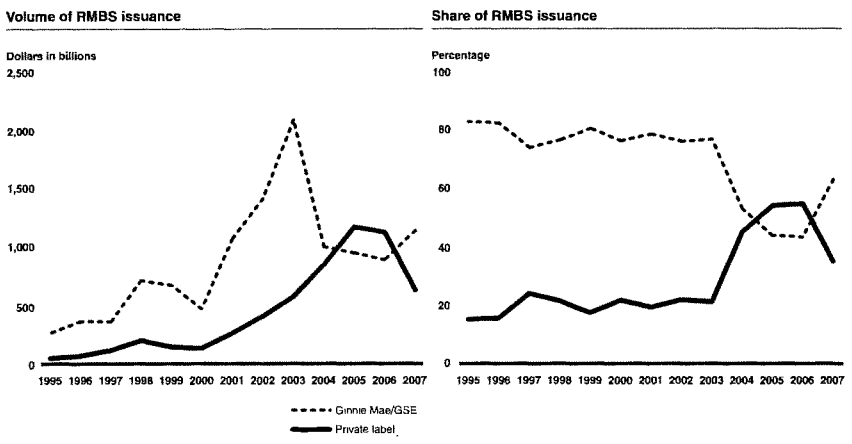
The increased role in recent years of investment banks securitizing and selling mortgage loans to investors further illustrates gaps in the regulatory system resulting from less-regulated institutions. Until recently, GSEs Fannie Mae and Freddie Mac were responsible for the vast majority of mortgage loan securitization. The securitization of loans that did not meet the GSEs' congressionally imposed loan limits or regulator-approved quality standards—such as jumbo loans that exceeded maximum loan limits and subprime loans—was undertaken by investment firms that were subject to little or no standards to ensure safe and sound practices in connection with the purchase or securitization of loans. As the volume of subprime lending grew dramatically from around 2003 through 2006, investment firms took over the substantial share of the mortgage securitization market. As shown in figure 4, this channel of mortgage funding—known as the private label mortgage-backed securities market—grew rapidly and in 2005 surpassed the combined market share of the GSEs and Ginnie Mae—a government corporation that guarantees mortgage-backed securities. As the volume of subprime loans increased, a rapidly growing share was packaged into private label securities, reaching

[40]GAO, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, GAO-04-280 (Washington, D.C.: Jan. 30, 2004); *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, GAO-06-1021 (Washington, D.C.: Sept. 19, 2006); and *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, GAO-08-78R (Washington, D.C.: Oct. 16, 2007).

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75 percent in 2006, according to the Federal Reserve Bank of San Francisco.

Figure 4: Growth in Proportion of Private Label Securitization in the Mortgage-Backed Securities Market, in Dollars and Percentage of Dollar Volume (1995-2007)



Source: GAO analysis of data from Inside Mortgage Finance

As shown in figure 4, this growth allowed private label securities to become approximately 55 percent of all mortgage-backed security issuance by 2005. This development serves as yet another example of how a less-regulated part of the market, private label securitization, played a significant role in fostering risky subprime mortgage lending, exposing a gap in the financial regulatory structure.

The role of mortgage brokers in the sale of mortgage products in recent years has also been a key focus of attention of policymakers. In past work, we noted that the role of mortgage brokers grew in the years leading up to the current crisis. By one estimate, the number of brokerages rose from about 30,000 firms in 2000 to 53,000 firms in 2004. In 2005, brokers

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accounted for about 60 percent of originations in the subprime market (compared with about 25 percent in the prime market).[41] In 2008, in the wake of the subprime mortgage crisis, Congress enacted the Secure and Fair Enforcement for Mortgage Licensing Act, as part of the Housing and Economic Recovery Act, to require enhanced licensing and registration of mortgage brokers.[42]

Activities of Hedge Funds Can Pose Systemic Risks Not Recognized by Regulatory System

Hedge funds, which are professionally managed investment funds for institutional and wealthy investors, have become significant participants in many important financial markets. For example, hedge funds often assume risks that other more regulated institutions are unwilling or unable to assume, and therefore generally are recognized as benefiting markets by enhancing liquidity, promoting market efficiency, spurring financial innovation, and helping to reallocate financial risk. But hedge funds receive less-direct oversight than other major market participants such as mutual funds, another type of investment fund that manages pools of assets on behalf of investors.[43] Hedge funds generally are structured and operated in a manner that enables them to qualify for exemptions from certain federal securities laws and regulations.[44] Because their participants are presumed to be sophisticated and therefore not require the full protection offered by the securities laws, hedge funds have not generally been subject to direct regulation. Therefore, hedge funds are not subject to regulatory capital requirements, are not restricted by regulation in their choice of investment strategies, and are not limited by regulation in their use of leverage. By soliciting participation in their funds from only certain large institutions and wealthy individuals and refraining from advertising to the general public, hedge funds are not required to meet the registration and disclosure requirements of the Securities Act of 1933 or the Securities Exchange Act of 1934, such as providing their investors with detailed prospectuses on the activities that their fund will undertake using

[41]GAO-08-78R.

[42]"Secure and Fair Enforcement for Mortgage Licensing Act of 2008" or "S.A.F.E. Mortgage Licensing Act of 2008", Pub. L. No. 110-289, title V.

[43]Although there is no statutory definition of hedge funds, the term is commonly used to describe pooled investment vehicles directed by professional managers that often engage in active trading of various types of assets such as securities and derivatives.

[44]See GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*, GAO-08-200 (Washington, D.C.: Jan. 24, 2008), 9.

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investors' proceeds.[45] Hedge fund managers that trade on futures exchanges and that have U.S. investors are required to register with CFTC and are subject to periodic reporting, recordkeeping, and disclosure requirements of their futures activities, unless they notify the Commission that they qualify for an exemption from registration.[46]

The activities of many, but not all, hedge funds have recently become subject to greater oversight from SEC, although the rule requiring certain hedge fund advisers to register as investment advisers was recently vacated by a federal appeals court. In December 2004, SEC amended its rules to require certain hedge fund advisers that had been exempt from registering with SEC as investment advisers under its "private adviser" exemption to register as investment advisers.[47] In August 2006, SEC estimated that over 2,500 hedge fund advisers were registered with the agency, although what percentage of all hedge fund advisers active in the United States that this represents is not known. Registered hedge fund advisers are subject to the same requirements as all other registered investment advisers, including providing current information to both SEC and investors about their business practices and disciplinary history, maintaining required books and records, and being subject to periodic SEC examinations. Some questions exist over the extent of SEC's authority over these funds. In June 2006, the U.S. Court of Appeals for the

[45]Under the Securities Act of 1933, a public offering or sale of securities must be registered with SEC, unless otherwise exempted. In order to exempt an offering or sale of hedge fund shares (ownership interests) to investors from registration under the Securities Act of 1933, most hedge funds restrict their sales to accredited investors in compliance with the safe harbor requirements of Rule 506 of Regulation D. See 15 U.S.C. § 77d and § 77e; 17 C.F.R. § 230.506 (2007). Such investors must meet certain wealth and income thresholds. In addition, hedge funds typically limit the number of investors to fewer than 500, so as not to fall within the purview of Section 12(g) of the Securities Exchange Act of 1934, which requires the registration of any class of equity securities (other than exempted securities) held of record by 500 or more persons. 15 U.S.C. § 78l(g).

[46]The registration and regulatory requirements applicable to Commodity Pool Operators and Commodity Trading Advisors are subject to various exceptions and exemptions contained in CFTC regulations. See, e.g., 17 C.F.R. Secs. 4.5 (exclusion from definition of CPO for pools subject to other types of regulation such as supervision as an insured depository institution, registration under the Investment Company Act of 1940, or state regulation as an insurance company), 4.7 (exemptions from disclosure requirements for CPOs and CTAs offering or selling interests to qualified eligible persons or directing or guiding their accounts), 4.12(b) (disclosure exemption for CPOs operating pools offered and sold pursuant to the 1933 Securities Act or an exemption from the Act), 4.13 (exemption from CPO registration), 4.14 (exemption from CTA registration).

[47]69 *Fed. Reg.* 72054 (Dec. 10, 2004).

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District of Columbia overturned SEC's amended rule, concluding that the rule was arbitrary because it departed, without reasonable justification, from SEC's long-standing interpretation of the term "client" in the private adviser exemption as referring to the hedge fund itself, and not to the individual investors in the fund.[48] However, according to SEC, most hedge fund advisers that previously registered have chosen to retain their registered status as of April 2007.

Although many hedge fund advisers are now subject to some SEC oversight, some financial regulators and market participants remain concerned that hedge funds' activities can create systemic risk by threatening the soundness of other regulated entities and asset markets. Hedge funds have important connections to the financial markets, including significant business relationships with the largest regulated commercial banks and broker-dealers. They act as trading counterparties with many of these institutions and constitute in many markets a significant portion of trading activity, from stocks to distressed debt and credit derivatives.[49]

The far-reaching consequences of potential hedge fund failures first became apparent in 1998. The hedge fund Long Term Capital Management (LTCM) experienced large losses related to the considerable positions—estimated to be as large as $100 billion—it had taken in various sovereign debt and other markets, and regulators coordinated with market participants to prevent a disorderly collapse that could have led to financial problems among LTCM's lenders and counterparties and potentially to the rest of the financial system.[50] No taxpayer funds were

[48]See *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). In Goldstein, the petitioner challenged an SEC regulation under the Investment Adviser's Act that defined "client" to include hedge fund investors and, therefore, prevented hedge fund advisers from qualifying for an exemption from registration for investment advisers with fewer than 15 clients. See *Goldstein*, 451 F.3d at 874-76. The Court of Appeals vacated the SEC's regulation. While hedge fund advisers may be exempt from registration, the anti-fraud provisions of the Advisers Act apply to all investment advisers, whether or not they are required to register under the Advisers Act. See Goldstein, 451 F.3d at 876. In August 2007, SEC adopted a final rule under the Investment Advisers Act (rule 206(4)–8 which prohibits advisers from (1) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (2) otherwise defrauding these investors. 72 *Fed. Reg.* 44756 (Aug. 9, 2007)).

[49]A counterparty is the opposite party in a bilateral agreement, contract, or transaction.

[50]GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999).

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used as part of this effort; instead, the various large financial institutions with large exposures to this hedge fund agreed to provide additional funding of $3.6 billion until the fund could be dissolved in an orderly way. Since LTCM, other hedge funds have experienced near collapses or failures, including two funds owned by Bear Stearns, but these events have not had as significant impact on the broader financial markets as LTCM.

Also, since LTCM's near collapse, investors, creditors, and counterparties have increased their efforts to impose market discipline on hedge funds. According to regulators and market participants, creditors and counterparties have been conducting more extensive due diligence and monitoring risk exposures to their hedge fund clients. In addition, hedge fund advisers have improved disclosure and become more transparent about their operations, including their risk-management practices. However, we reported in 2008 that some regulators continue to be concerned that the counterparty credit risk created when regulated financial institutions transact with hedge funds can be a primary channel for potentially creating systemic risk.[51]

Credit Rating Agency Activities Also Illustrate the Failure of the Regulatory System to Address Risks Posed by Less-Regulated Entities

Similar to hedge funds, credit rating agencies have come to play a critical role in financial markets, but until recently they received little regulatory oversight. While not acting as direct participants in financial markets, credit ratings are widely used by investors for distinguishing the creditworthiness of bonds and other securities. Additionally, credit ratings are used in local, federal, and international laws and regulations as a benchmark for permissible investments by banks, pension funds, and other institutional investors. Leading up to the recent crisis, some investors had come to rely heavily on ratings in lieu of conducting independent assessments on the quality of assets. This overreliance on credit ratings of subprime mortgage-backed securities and other structured credit products contributed to the recent turmoil in financial markets. As these securities started to incur losses, it became clear that their ratings did not adequately reflect the risk that these products ultimately posed. According to the trade publication *Inside B&C Lending*, the three major credit rating agencies have each downgraded more than half of the subprime mortgage-backed securities they originally rated between 2005 and 2007.

[51]See GAO-08-200. Counterparty credit risk is the risk that a loss will be incurred if a counterparty to a transaction does not fulfill its financial obligations in a timely manner.

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However, despite the critical nature of these rating agencies in our financial system, the existing regulatory system failed to adequately foresee and manage their role in recent events. Until recently, credit rating agencies received little direct oversight and thus faced no explicit requirements to provide information to investors about how to understand and appropriately use ratings, or to provide data on the accuracy of their ratings over time that would allow investors to assess their quality. In addition, concerns have been raised over whether the way in which credit rating agencies are compensated by the issuers of the securities that they rate affects the quality of the ratings awarded. In a July 2008 report, SEC noted multiple weaknesses in the management of these conflicts of interest, including instances where analysts expressed concerns over fees and other business interests when issuing ratings and reviewing ratings criteria.[52] However, until 2006, no legislation had established statutory regulatory authority or disclosure requirements over credit rating agencies.[53] Then, to improve the quality of ratings in response to events such as the failures of Enron and Worldcom—which highlighted the limitations of credit ratings in identifying companies' financial strength—Congress passed the Credit Rating Agency Reform Act of 2006, which established limited SEC oversight, requiring their registration and certain recordkeeping and reporting requirements.[54]

[52]SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (Washington, D.C., July 8, 2008).

[53]Previously, SEC regulations referred to credit ratings by "nationally recognized statistical rating organizations," or NRSROs, but this designation was not established or defined in statute. SEC staff identified credit rating agencies as NRSROs through a no-action letter process in which they determine whether a rating agency had achieved broad market acceptance for its ratings.

[54]Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (Sept. 29, 2006). Under the act, a credit rating agency seeking to be treated as an NRSRO must apply for, and be granted, registration with SEC, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. In addition, the act provides the SEC with rulemaking authority to prescribe: the form of the application (including requiring the furnishing of additional information); the records an NRSRO must make and retain; the financial reports an NRSRO must furnish to SEC on a periodic basis; the specific procedures an NRSRO must implement to manage the handling of material nonpublic information; the conflicts of interest an NRSRO must manage or avoid altogether; and the practices that an NRSRO must not engage in if SEC determines they are unfair, coercive, or abusive. The act expressly prohibits SEC from regulating the rating agencies' methodologies or the substance of their ratings. Pub. L. No. 109-291 § 4(a). SEC adopted rules implementing the act in June 2007. 72 *Fed. Reg.* 33564 (June 18, 2007).

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Since the financial crisis began, regulators have taken steps to address the important role of rating agencies in the financial system. In December 2008, in response to the subprime mortgage crisis and resulting credit market strains, SEC adopted final rule amendments and proposed new rule amendments that would impose additional requirements on nationally recognized statistical rating organizations in order to address concerns raised about the policies and procedures for, transparency of, and potential conflicts of interest relating to ratings. Determining the most appropriate government role in overseeing credit rating activities is difficult. For example, SEC has expressed concerns that too much government intervention—such as regulatory requirements of credit ratings for certain investments or examining the underlying methodology of ratings—would unintentionally provide an unofficial "seal of approval" on the ratings and therefore be counterproductive to reducing overreliance on ratings. Whatever the solution, it is clear that the current regulatory system did not properly recognize and address the risks associated with the important role these entities played.

Regulatory System Failed to Identify Risks Associated with Special-Purpose Entities

The use by financial institutions of special-purpose entities provides another example of how less-regulated aspects of financial markets came to play increasingly important roles in recent years, creating challenges for regulators in overseeing risks at their regulated institutions. Many financial institutions created and transferred assets to these entities as part of securitizations for mortgages or to hold other assets and produce fee income for the institution that created it—known as the sponsor. For example, after new capital requirements were adopted in the late 1980s, some large banks began creating these entities to hold assets for which they would have been required to hold more capital against if the assets were held within their institutions. As a result, these entities are also known as off-balance sheet entities because they generally are structured in such a way that their assets and liabilities are not required to be consolidated and reported as part of the overall balance sheet of the sponsoring financial institution that created them. The amount of assets accumulated in these entities resulted in them becoming significant market participants in the last few years. For example, one large commercial bank reported that its off-balance sheet entities totaled more than $1 trillion in assets at the end of 2007.

Some of these off-balance sheet entities were structured in a way that left them vulnerable to market disruptions. For example, some financial institutions created entities known as asset-backed commercial paper conduits that would purchase various assets, including mortgage-related securities, financial institution debt, and receivables from industrial

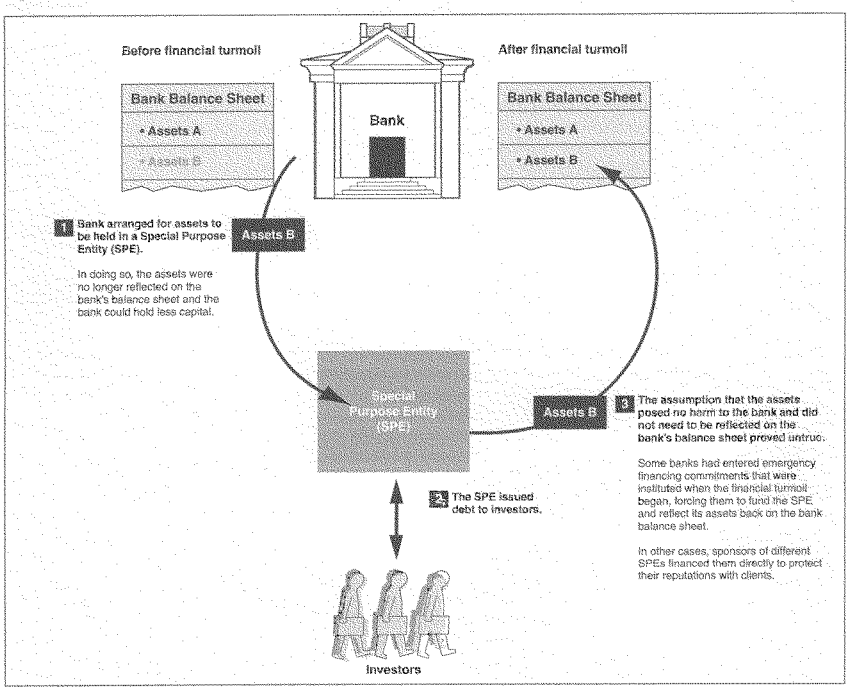
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businesses. To obtain the funds to purchase these assets, these special-purpose vehicles often borrowed using shorter-term instruments, such as commercial paper and medium-term notes. The difference between the interest paid to the commercial paper or note holders and the income earned on the entity's assets produced fee and other income for the sponsoring institution. However, these structures carried the risk that the entity would find it difficult or costly to renew its debt financing under less-favorable market conditions.

Although structured as off-balance sheet entities, when the turmoil in the markets began in 2007, many financial institutions that had created these entities had to take back the loans and securities in certain types of these off-balance sheet entities. (See fig. 5.)

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Figure 5: Example of an Off-Balance Sheet Entity


Before financial turmoil
Bank Balance Sheet
• Assets A
• Assets B
Bank
After financial turmoil
Bank Balance Sheet
• Assets A
• Assets B
1 Bank arranged for assets to be held in a Special Purpose Entity (SPE).
In doing so, the assets were no longer reflected on the bank's balance sheet and the bank could hold less capital.
Assets B
Special Purpose Entity (SPE)
Assets B
3 The assumption that the assets posed no harm to the bank and did not need to be reflected on the bank's balance sheet proved untrue.
Some banks had entered emergency financing commitments that were instituted when the financial turmoil began, forcing them to fund the SPE and reflect its assets back on the bank balance sheet.
In other cases, sponsors of different SPEs financed them directly to protect their reputations with clients.
2 The SPE issued debt to investors.
Investors

Source: GAO.

In general, banks stepped in to finance the assets held by these entities when they were unable to refinance their expiring debt due to market concerns over the quality of the assets. In some cases, off-balance sheet entities relied on emergency financing commitments that many sponsoring banks had extended to these entities. In other cases, financial institutions supported troubled off-balance sheet entities to protect their reputations

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with clients even when no explicit requirement to do so existed. This, in turn, contributed to the reluctance of banks to lend as they had to fund additional troubled assets on their balance sheets. Thus, although the use of these entities seemingly had removed the risk of these assets from these institutions, their inability to obtain financing resulted in the ownership, risks, and losses of these entities' assets coming back into many of the sponsoring financial institutions.

According to a 2008 IMF study, financial institutions' use of off-balance sheet entities made it difficult for regulators, as well as investors, to fully understand the associated risks of such activities. In response to these developments, regulators and others have begun to reassess the appropriateness of the regulatory and accounting treatment for these entities. In January 2008, SEC asked the Financial Accounting Standards Board (FASB), which establishes U.S. financial accounting and reporting standards, to consider further improvements to the accounting and disclosure for off-balance sheet transactions involving securitization. FASB and the International Accounting Standards Board both have initiated projects to improve the criteria for determining when financial assets and related liabilities that institutions transfer to special-purpose entities should be included on the institutions' own balance sheets—known as consolidation—and to enhance related disclosures. As part of this effort, FASB issued proposed standards that would eliminate a widely used accounting exception for off-balance sheet entities, introduce a new accounting model for determining whether special-purpose entities should be consolidated that is less reliant on mathematical calculations and more closely aligned with international standards, and require additional disclosures about institutions' involvement with certain special-purpose entities. On December 18, 2008, the International Accounting Standards Board also issued a proposed standard on consolidation of special-purpose entities and related risk disclosures. In addition, in April 2008, the Basel Committee on Banking Supervision announced new measures to capture off-balance sheet exposures more effectively.

Nevertheless, this serves as another example of the failure of the existing regulatory system to recognize the problems with less-regulated entities and take steps to address them before they escalate. Existing accounting and disclosure standards had not required banks to extensively disclose their holdings in off-balance sheet entities and allowed for very low capital requirements. As a March 2008 study by the President's Working Group on Financial Markets noted, before the recent market turmoil, supervisory authorities did not insist on appropriate disclosures of firms' potential exposure to off-balance sheet entities.

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New and Complex Financial Products and Services Also Revealed Limitations in the Regulatory Structure

Another development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. Although posing challenges, these new products also have provided certain benefits to financial markets and consumers. For example, the creation of securitized products such as mortgage-backed securities increased the liquidity of credit markets by providing additional funds to lenders and a wider range of investment returns to investors with excess funds. Other useful product innovations included OTC derivatives, such as currency options, which provide a purchaser the right to buy a specified quantity of a currency at some future date, and interest rate swaps, which allow one party to exchange a stream of fixed interest rate payments for a stream of variable interest rate payments. These products help market participants hedge their risks or stabilize their cash flows. Alternative mortgage products, such as interest-only loans, originally were used by a limited subset of the population, mainly wealthy borrowers, to obtain more convenient financing for home purchases. Despite these advantages, the complexity and expanded use of new products has made it difficult for the current regulatory system to oversee risk management at institutions and adequately protect individual consumers and investors.

New Complex Securitized Products Have Created Difficulties for Institutions and Regulators in Valuing and Assessing Their Risks

Collateralized debt obligations (CDO) are one of the new products that proliferated and created challenges for financial institutions and regulators. In a basic CDO, a group of loans or debt securities are pooled and securities are then issued in different tranches that vary in risk and return depending on how the underlying cash flows produced by the pooled assets are allocated. If some of the underlying assets defaulted, the more junior tranches—and thus riskier ones—would absorb these losses first before the more senior, less-risky tranches. Purchasers of these CDO securities included insurance companies, mutual funds, commercial and investment banks, and pension funds. Many CDOs in recent years largely consisted of mortgage-backed securities, including subprime mortgage-backed securities.

Although CDOs have existed since the 1980s, recent changes in the underlying asset mix of these products led to increased risk that was poorly understood by the financial institutions involved in these investments. CDOs had consisted of simple securities like corporate bonds or loans, but more recently have included subprime mortgage-backed securities, and in some cases even lower-rated classes of other equally complex CDOs. Some of these CDOs included investments in 100 or more

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asset-backed securities, each of which had its own large pool of loans and specific payment structures.[55] A large share of the total value of the securities issued were rated AA or AAA—designating them as very safe investments and unlikely to default—by the credit rating agencies. In part because of their seemingly high returns in light of their rated risk, demand for these new CDOs grew rapidly and on a large scale. Between 2004 and 2007, nearly all adjustable-rate subprime mortgages were packaged into mortgage-backed securities, a large portion of which were structured into CDOs.

As housing prices in the United States softened in the last 2 years, default and foreclosure rates on the mortgages underlying many CDOs rose and the credit rating agencies downgraded many CDO ratings, causing investors to become unwilling to purchase these products in the same quantities or at the prices previously paid. Many financial institutions, including large commercial and investment banks, struggled to realize the size of their exposure to subprime credit risk. Many of these institutions appeared to have underestimated the amount of risk and potential losses that they could face from creating and investing in these products. Reductions in the value of subprime-backed CDOs have contributed to reported losses by financial institutions totaling more than $750 billion globally, as of September 2008, according to the International Monetary Fund, which estimates that total losses on global holdings of U.S. loans and securities could reach $1.4 trillion.

Several factors could explain why institutions—and regulators—did not effectively monitor and limit the risk that CDOs represented. Products like CDOs have risk characteristics that differ from traditional investments. First, the variation and complexity of the CDO structures and the underlying assets they contain often make estimating potential losses and determining accurate values for these products more difficult than for traditional securities. Second, although aggregating multiple assets into these structures can diversify and thus reduce the overall risk of the securities issued from them, their exposure to the overall housing market downturn made investors reluctant to purchase even the safest tranches, which produced large valuation losses for the holders of even the highest-

[55]CDO cash flows also can be affected by other contract terms, such as detailed provisions that divert payments from the junior classes to the more senior classes when certain conditions are met, such as if the portfolio value or interest proceeds fall below a certain level.

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rated CDO securities.[56] Finally, Federal Reserve staff noted that an additional reason these securities performed worse than expected was that rating agencies and investors did not believe that housing prices could have fallen as significantly as they have.

The lack of historical performance data for these new instruments also presented challenges in estimating the potential value of these securities. For example, the Senior Supervisors Group—a body comprising senior financial supervisors from France, Germany, Switzerland, the United Kingdom, and the United States—reported that some financial institutions substituted price and other data associated with traditional corporate debt in their loss estimation models for similarly rated CDO debt, which did not have sufficient historical data.[57] As a report by a group of senior representatives of financial regulators and institutions has noted, the absence of historical information on the performance of CDOs created uncertainty around the standard risk-management tools used by financial institutions.[58] Further, structured products such as CDOs may lack an active and liquid market, as in the recent period of market stress, forcing participants to look for other sources of valuation information when market prices are not readily available. For instance, market participants often turned to internal models and other methods to value these products, which raised concerns about the consistency and accuracy of the resulting valuation information.

Growth in OTC Derivatives Markets, Which Feature Complex Products That Are Not Regulated, Raised Regulator Concerns about Systemic Risk and Weak Market Infrastructure

The rapid growth in OTC derivatives—or derivatives contracts that are traded outside of regulated exchanges—is another example of how the emergence of large markets for increasingly complex products has challenged our financial regulatory system. OTC derivatives, which began trading in the 1980s, have developed into markets with an estimated notional value—which is the amount underlying a financial derivatives contract—of about $596 trillion, as of December 2007, according to the

[56]For more information, see The Joint Forum, Bank for International Settlements, *Credit Risk Transfer: Developments from 2005 to 2007* (Basel, Switzerland, April 2008).

[57]See the Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (New York, Mar. 6, 2008).

[58]See the Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (Basel, Switzerland, Apr. 7, 2008). The Financial Stability Forum promotes international financial stability through information exchange and international cooperation in financial supervision and surveillance. It is composed of senior representatives of national financial authorities and various international financial organizations and the European Central Bank.

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Bank for International Settlements.[59] OTC derivatives transactions are generally not subject to regulation by SEC, CFTC, or any other U.S. financial regulator and in particular are not subject to similar disclosure and other requirements that are in place for most securities and exchange-traded futures products. Institutions that conduct derivatives transactions may be subject to oversight of their lines of business by their regulators. For example, commercial banks that deal in OTC derivatives are subject to full examinations by their respective regulators. On the other hand, investment banks generally conducted their OTC derivatives activities in affiliates or subsidiaries that traditionally—since most OTC derivatives are not securities—were not subject to direct oversight by SEC, although SEC did review how the largest investment banks that were subject to its CSE program were managing the risk of such activities.

Although OTC derivatives and their markets are not directly regulated, the risk exposures that these products created among regulated financial institutions can be sometimes large enough to raise systemic risk concerns among regulators. For example, Bear Stearns, the investment bank that experienced financial difficulties as the result of its mortgage-backed securities activities, was also one of the largest OTC derivatives dealers. According to regulators, one of the primary reasons the Federal Reserve, which otherwise had no regulatory authority over this securities firm, facilitated the sale of Bear Stearns rather than let it go bankrupt was to avoid a potentially large systemic problem because of the firm's large OTC derivatives obligations. More than a decade ago, we reported that the large financial interconnections between derivatives dealers posed risk to the financial system and recommended that Congress and financial regulators take action to ensure that the largest firms participating in the OTC derivatives markets be subject to similar regulatory oversight and requirements.[60]

[59]The notional amount is the amount upon which payments between parties to certain types of derivatives contracts are based. When this amount is not exchanged, it is not a measure of the amount at risk in a transaction. According to the Bank for International Settlements, the amount at risk, as measured by the gross market value of OTC derivatives outstanding, was $15 trillion, as of December 2007, or about 2 percent of the notional/contract amount. (The gross market value is the cost that would be incurred if the outstanding contracts were replaced at prevailing market prices.)

[60]GAO, *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133 (Washington, D.C.: May 18, 1994).

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The market for one type of OTC derivative—credit default swaps—had grown so large that regulators became concerned about its potential to create systemic risks to regulated financial institutions. Credit default swaps are contracts that act as a type of insurance, or a way to hedge risks, against default or another type of credit event associated with a security such as a corporate bond. One party in the contract—the seller of protection—agrees, in return for a periodic fee, to compensate the other party—the protection buyer—if the bond or other underlying entity defaults or another specified credit event occurs. In recent years, the size of the market for credit default swaps (in terms of the notional amount of outstanding contracts) has increased almost tenfold from just over $6 trillion in 2004 to almost $58 trillion at the end of 2007, according to the Bank for International Settlements.

As this market has grown, regulators increasingly have become concerned about the adequacy of the infrastructure in place for clearing and settling these contracts, especially the ability to quickly resolve contracts in the event of a large market participant failure. For example, in September 2008, concerns over the effects that a potential bankruptcy of AIG—which was a large seller of credit default swaps—would have on this firm's swap counterparties contributed to a decision by the Federal Reserve to lend the firm up to $85 billion.[61] The Federal Reserve expressed concern at the time that a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. As with other OTC derivatives, credit default swaps are not regulated as products, but many of the large U.S. and internationally regulated financial institutions act as dealers. Despite the credit default market's rapid growth, as recently as 2005 the processing of transactions was still paper-based and decentralized. Regulators have put forth efforts over the years to strengthen clearing and settlement mechanisms. For example, in September 2005, the Federal Reserve Bank of New York began working with dealers and market participants to strengthen arrangements for clearing and settling these swap transactions. Regulators began focusing on reducing a large backlog of unconfirmed trades, which can inhibit market participants' ability to manage their risks if errors are not found quickly or if uncertainty exists about how other institutions would

[61]Subsequently, the Federal Reserve agreed to loan AIG up to an additional $38 billion. In November 2008, the Federal Reserve and U.S. Treasury restructured these lending arrangements with a new financial support package totaling over $150 billion.

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be affected by the failure of a firm with which they hold credit default swap contracts. Regulators continue to monitor dealers' progress on these efforts to reduce operational risk arising from these products, and recently have begun holding discussions with the largest credit derivatives dealers and other entities, including certain exchanges, regarding the need to establish a centralized clearing facility, which could reduce the risk of any one dealer's failure to the overall system. In November 2008, the President's Working Group on Financial Markets announced policy objectives to guide efforts to address challenges associated with OTC derivatives, including recommendations to enhance the market infrastructure for credit default swaps. However, as of December 2008, no such entity had begun operations.

New Complex Products Have Also Created Challenges for Regulators in Ensuring Adequate Investor and Consumer Protection

The regulations requiring that investors receive adequate information about the risks of financial assets being marketed to them are also being challenged by the development of some of these new and complex products. For some of the new products that have been created, market participants sometimes had difficulty obtaining clear and accurate information on the value of these assets, their risks, and other key information. In some cases, investors did not perform needed due diligence to fully understand the risks associated with their investment. In other cases, investors have claimed they were misled by broker-dealers about the advantages and disadvantages of products. For example, investors for municipal governments in Australia have accused Lehman Brothers of misleading them regarding the risks of CDOs. As another example, the treasurer of Orange County who oversaw investments leading to the county's 1994 bankruptcy claimed to have relied on the advice of a large securities firm for his decision to pursue leveraged investments in complex structured products. Finally, a number of financial institutions—including Bank of America, Wachovia, Merrill Lynch, and UBS—have recently settled SEC allegations that these institutions misled investors in selling auction-rate securities, which are bonds for which the interest rates are regularly reset through auctions. In one case, Bank of America, in October 2008, reached a settlement in principle in response to SEC charges that it made misrepresentations to thousands of businesses, charities, and institutional investors when it told them that the products were safe and highly liquid cash and money market alternative investments.

Similarly, the introduction and expansion of increasingly complicated retail products to new and broader consumer populations has also raised challenges for regulators in ensuring that consumers are adequately protected. Consumers face growing difficulty in understanding the relative

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advantages and disadvantages of products such as mortgages and credit cards with new and increasingly complicated features, in part because of limitations on the part of regulatory agencies to improve consumer disclosures and financial literacy. For example, in the last few years many borrowers likely did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate at which they had been in recent years. In particular, a significant majority of subprime borrowers from 2003 to 2006 took out adjustable-rate mortgages whose interest rates were fixed for the first 2 or 3 years but then adjusted to often much higher interest rates and correspondingly higher mortgage payments. In addition, many borrowers took out loans with interest-only features that resulted in significant increases in mortgage payments later in the loan. The combination of reduced underwriting standards and a slowdown in house price appreciation led many borrowers to default on their mortgages.

Alternative mortgage products such as interest-only or payment option loans, which allow borrowers to defer repayment of principal and possibly part of the interest for the first few years of the loan, grew in popularity and expanded greatly in recent years. From 2003 through 2005, originations of these types of mortgage products grew threefold, from less than 10 percent of residential mortgage originations to about 30 percent. For many years, lenders had primarily marketed these products to wealthy and financially sophisticated borrowers as financial management tools. However, lenders increasingly marketed alternative mortgage products as affordability products that enabled a wider spectrum of borrowers to purchase homes they might not have been able to afford using a conventional fixed-rate mortgage. Lenders also increased the variety of such products offered after interest rates rose and adjustable rate mortgages became less attractive to borrowers.

In past work, we found that most of the disclosures for alternative mortgage products that we reviewed did not always fully or effectively explain the risks associated with these products and lacked information on some important loan features.[62] Some evidence suggests more generally that existing mortgage disclosures were inadequate, a problem that is likely to grow with the increased complexity of products. A 2007 Federal Trade Commission report found that both prime and subprime borrowers

[62]See GAO-06-1021.

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failed to understand key loan terms when viewing current disclosures.[63] In addition, some market observers have been critical of regulators' oversight of these products and whether products with such complex features were appropriate for some of the borrowers to which they were marketed. For example, some were critical of the Federal Reserve for not acting more quickly to use its authority under the 1994 Home Ownership and Equity Protection Act to prohibit unfair or deceptive acts or practices in the mortgage market. Although the Federal Reserve took steps in 2001 to ban some practices, such as engaging in a pattern or practice of refinancing certain high-cost loans when it is not in the borrower's interest, it did not act again until 2008, when it banned additional products and practices, such as certain loans with limited documentation. In a 2007 testimony, a Federal Reserve official noted that writing such rules is difficult, particularly since determinations of unfairness or deception depend heavily on the facts of an individual case.[64]

Efforts by regulators to respond to the increased risks associated with new mortgage products also have sometimes been slowed in part because of the need for five federal regulators to coordinate their response. In late 2005, regulators began crafting regulatory guidance to strengthen lending practices and improve disclosures for loans that start with relatively low payments but leave borrowers vulnerable to much higher ones later. The regulators completed their first set of such standards in September 2006, with respect to the disclosure of risks associated with nontraditional mortgage products, and a second set, applicable to subprime mortgage loans, in June 2007.[65] Some industry observers and consumer advocacy groups have criticized the length of time it took for regulators to issue these changes, noting that the second set of guidance was released well after many subprime lenders had already gone out of business.

[63]Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms: A Bureau of Economics Staff Report.* (Washington D.C.: June 2007).

[64]House of Representatives Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Subprime Mortgages*, 110th Cong. 2nd sess., Mar. 27, 2007 (testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Federal Reserve).

[65]71 *Fed. Reg.* 58609 (Oct. 4, 2006) "Interagency Guidance on Nontraditional Mortgage Product Risks"; 72 *Fed. Reg.* 37569 (Jul. 10, 2007) "Statement on Subprime Mortgage Lending".

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As variations in the types of credit card products and terms have proliferated, consumers also have faced difficulty understanding the rates and terms of their credit card accounts. Credit card rate and fee disclosures have not always been effective at clearly conveying associated charges and fees, creating challenges to informed financial decision making. Although credit card issuers are required to provide cardholders with information aimed at facilitating informed use of credit, these disclosures have serious weaknesses that likely reduce consumers' ability to understand the costs of using credit cards. Because the pricing of credit cards is not generally subject to federal regulation, these disclosures are the primary federal consumer protection mechanism against inaccurate and unfair credit card practices. However, we reported in 2006 that the disclosures in materials provided by four of the largest credit card issuers were too complicated for many consumers to understand. Following our report, Federal Reserve staff began using consumer testing to involve them to a greater extent in the preparation of potentially new and revised disclosures, and in May 2007, issued proposed changes to credit card disclosure requirements. Nonetheless, the Federal Reserve recognizes the challenge of presenting the information that consumers may need to understand the costs of their cards in a clear way, given the increasingly complicated terms of credit card products.[66] In December 2008, the Federal Reserve, OTS, and NCUA finalized rules to ban various unfair credit card practices, such as allocating payments in a way that unfairly maximizes interest charges.

The expansion of new and more complex products also raises challenges for regulators in addressing financial literacy. We have also noted in past work that even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters.[67] In response to increasing evidence that many Americans are lacking in financial literacy, the federal government has taken steps to expand financial education efforts. However, attempts by the Financial Literacy and Education Commission to coordinate federal financial literacy efforts have sometimes proven difficult due, in part, to the need to reach consensus among its 20 participating federal agencies, which have different missions and perspectives. Moreover, the commission's staff and

[66]See GAO, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO-06-929 (Washington, D.C.: Sept. 12, 2006).

[67]See GAO-04-280.

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funding resources are relatively small, and it has no legal authority to require agencies to redirect their resources or take other actions.[68]

Increased Complexity and Other Factors Have Challenged Accounting Standard Setters and Regulators

As new and increasingly complex financial products have become more common, FASB and SEC have also faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.[69] The development and widespread use of increasingly complex financial products has heightened the importance of having effective accounting and financial reporting requirements that provide interested parties with information that can help them identify and assess risk. As the pace of financial innovation increased in the last 30 years, accounting and financial reporting requirements have also had to keep pace, with 72 percent of the current 163 standards having been issued since 1980—some of which were revisions and amendments to recently established standards, which evidences the challenge of establishing accounting and financial reporting requirements that respond to needs created by financial innovation.

As a result of the growth in complex financial instruments and a desire to improve the usefulness of financial information about them, U.S. standard setters and regulators currently are dealing with accounting and auditing challenges associated with recently developed standards related to valuing financial instruments and special-purpose entities. Over the last year, owners and issuers of financial instruments have expressed concerns about implementing the new fair value accounting standard, which requires that financial assets and liabilities be recorded at fair or market value. SEC and FASB have recently issued clarifications of measuring fair value when there is not an active market for the financial instrument.[70] In addition, market participants raised concerns about the availability of

[68]See GAO, *Financial Literacy and Education Commission: Further Progress Needed to Ensure an Effective National Strategy*, GAO-07-100 (Washington, D.C.: Dec. 4, 2006).

[69]FASB issues generally accepted accounting principles for financial statements prepared by nongovernmental entities in the United States. SEC issues financial reporting and disclosure requirements for U.S. publicly traded companies and recognizes the standards issued by FASB as "generally accepted" within the United States. SEC oversees FASB's standard-setting activities.

[70]FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (Oct. 10, 2008); and SEC Press Release No. 2008-234, *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting* (Sept. 30, 2008).

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useful accounting and financial reporting information to assess the risks posed by special-purpose entities. Under current accounting rules, publicly traded companies that create qualifying special-purpose entities are allowed to move qualifying assets and liabilities associated with certain complex financial instruments off the issuing company's balance sheets, which results in virtually no accounting and financial reporting information being available about the entities' activities. Due to the accounting and financial reporting treatment for these special-purpose entities, as the subprime crisis worsened, banks initially refused to negotiate loans with homeowners because banks were concerned that the accounting and financial reporting requirements would have the banks put the assets and liabilities back onto their balance sheets. In response to questions regarding modification of loans in special-purpose entities, the SEC's Chief Accountant issued a letter that concluded his office would not object to loans being modified pursuant to specific screening criteria. In response to these concerns, FASB expedited its standards-setting process in order to reduce the amount of time before the issuance of a new accounting standard that would effectively eliminate qualified special-purpose entities.[71]

Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards. The rapid integration of the world's capital markets has made establishing a single set of effective accounting and financial reporting standards increasingly relevant. FASB and SEC have acknowledged the need to address the convergence of U.S. and international accounting standards, and SEC has proposed having U.S. public companies use International Financial Reporting Standards by 2014. As the globalization of accounting standards moves forward, U.S. standard setters and regulators need to anticipate and manage the challenges posed by their development and implementation, such as how to apply certain standards in unique legal and regulatory environment frameworks in the United States as well as in certain unique industry niches. Ensuring that auditing standards applicable to U.S. public companies continue to provide the financial markets with the important

[71]On September 15, 2008, FASB issued an exposure draft, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, for a 30-day comment period that closed on October 15, 2008. On December 11, 2008, FASB issued FASB Staff Position (FSP) FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. This document requires additional disclosures about transfers of financial assets and variable interests in qualifying special purpose entities. It also requires public enterprises to provide additional disclosures about their involvement with variable interest entities.

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and independent assurances associated with existing U.S. auditing standards will also prove challenging to the Public Company Accounting Oversight Board.

Globalization Will Further Challenge the Existing U.S. Regulatory System

Just as global accounting and auditing standards are converging, financial markets around the world are becoming increasingly interlinked and global in nature, requiring U.S. regulators to work with each other and other countries to effectively adapt. To effectively oversee large financial services firms that have operations in many countries, regulators from various countries must coordinate regulation and supervision of financial services across national borders and must communicate regularly. Although financial regulators have effectively coordinated in a number of ways to accommodate some changes, the current fragmented regulatory structure has complicated some of these efforts.

For example, the current U.S. regulatory system complicates the ability of financial regulators to convey a single U.S. position in international discussions, such as those related to the Basel Accords process for developing international capital standards. Each federal regulator involved in these efforts oversees a different set of institutions and represents an important regulatory perspective, which has made reaching consensus on some issues more difficult than others. Although U.S. regulators generally agree on the broad underlying principles at the core of Basel II, including increased risk sensitivity of capital requirements and capital neutrality, in a 2004 report we noted that although regulators communicated and coordinated, they sometimes had difficulty agreeing on certain aspects of the process.[72] As we reported, in November 2003, members of the House Financial Services Committee warned in a letter to the bank regulatory agencies that the discord surrounding Basel II had weakened the negotiating position of the United States and resulted in an agreement that was less than favorable to U.S. financial institutions.[73] International officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making. However, regulatory officials told us that the final outcome of the Basel II negotiations was better than it would have been with a single U.S. representative because of the agencies' varying perspectives and expertise. In particular, one regulator noted that, in light of the magnitude

[72]GAO-05-61.

[73]Letter from Representative Michael Oxley et al. to Chairman Alan Greenspan et al., Nov. 3, 2003.

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of recent losses at banks and the failure of banks and rating agencies to predict such losses, the additional safeguards built into how U.S. regulators adopted Basel II are an example of how more than one regulatory perspective can improve policymaking.

A Framework for Crafting and Assessing Alternatives for Reforming the U.S. Financial Regulatory System

The U.S. regulatory system is a fragmented and complex system of federal and state regulators—put into place over the past 150 years—that has not kept pace with the major developments that have occurred in financial markets and products in recent decades. In 2008, the United States finds itself in the midst of one of the worst financial crises ever, with instability threatening global financial markets and the broader economy. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, attention has also turned to the need to consider significant reforms to the financial regulatory system to keep pace with existing and anticipated challenges in financial regulation.

While the current U.S. system has many features that could be preserved, the significant limitations of the system, if not addressed, will likely fail to prevent future crises that could be as harmful as or worse than those that have occurred in the past. Making changes that better position regulators to oversee firms and products that pose risks to the financial system and consumers and to adapt to new products and participants as these arise would seem essential to ensuring that our financial services sector continues to serve our nation's needs as effectively as possible.

We have conducted extensive work in recent decades reviewing the impacts of market developments and overseeing the effectiveness of financial regulators' activities. In particular, we have helped Congress address financial crises dating back to the savings and loan and LTCM crises, and more recently over the past few years have issued several reports citing the need to modernize the U.S. financial regulatory structure. In this report, consistent with our past work, we are not proposing the form and structure of what a new financial regulatory system should look like. Instead, we are providing a framework, consisting of the following nine elements, that Congress and others can use to evaluate or craft proposals for financial regulatory reform. By applying the elements of this framework to proposals, the relative strengths and weaknesses of each one should be better revealed. Similarly, the framework we present could be used to craft a proposal or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system. The nine

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elements could be addressed in a variety of ways, but each is critically important in establishing the most effective and efficient financial regulatory system possible.

1. *Clearly defined regulatory goals.* A regulatory system should have goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.

A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of a dynamic financial services industry is to clearly define regulatory goals and objectives. In the background of this report, we identify four broad goals of financial regulation that regulators have generally sought to achieve. These include ensuring adequate consumer protections, ensuring the integrity and fairness of markets, monitoring the safety and soundness of institutions, and acting to ensure the stability of the overall financial system. However, these goals are not always explicitly set in the federal statutes and regulations that govern these regulators. Having specific goals clearly articulated in legislation could serve to better focus regulators on achieving their missions with greater certainty and purpose, and provide continuity over time.

Given some of the key changes in financial markets discussed earlier in this report—particularly the increased interconnectedness of institutions, the increased complexity of products, and the increasingly global nature of financial markets—Congress should consider the benefits that may result from re-examining the goals of financial regulation and making explicit a set of comprehensive and cohesive goals that reflect today's environment. For example, it may be beneficial to have a clearer focus on ensuring that products are not sold with unsuitable, unfair, deceptive, or abusive features; that systemic risks and the stability of the overall financial system are specifically addressed; or that U.S. firms are competitive in a global environment. This may be especially important given the history of financial regulation and the ad hoc approach through which the existing goals have been established, as discussed earlier.

We found varying views about the goals of regulation and how they should be prioritized. For example, representatives of some regulatory agencies and industry groups emphasized the importance of creating a competitive financial system, whereas members of one consumer advocacy group noted that reforms should focus on improving regulatory effectiveness rather than addressing concerns about market competitiveness. In

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addition, as the Federal Reserve notes, financial regulatory goals often will prove interdependent and at other times may conflict.

Revisiting the goals of financial regulation would also help ensure that all involved entities—legislators, regulators, institutions, and consumers—are able to work jointly to meet the intended goals of financial regulation. Such goals and objectives could help establish agency priorities and define responsibility and accountability for identifying risks, including those that cross markets and industries. Policymakers should also carefully define jurisdictional lines and weigh the advantages and disadvantages of having overlapping authorities. While ensuring that the primary goals of financial regulation—including system soundness, market integrity, and consumer protection—are better articulated for regulators, policymakers will also have to ensure that regulation is balanced with other national goals, including facilitating capital raising, innovation, and other benefits that foster long-term growth, stability, and welfare of the United States.

Once these goals are agreed upon, policymakers will need to determine the extent to which goals need to be clarified and specified through rules and requirements, or whether to avoid such specificity and provide regulators with greater flexibility in interpreting such goals. Some reform proposals suggest "principles-based regulation" in which regulators apply broad-based regulatory principles on a case-by-case basis. Such an approach offers the potential advantage of allowing regulators to better adapt to changing market developments. Proponents also note that such an approach would prevent institutions in a more rules-based system from complying with the exact letter of the law while still engaging in unsound or otherwise undesirable financial activities. However, such an approach has potential limitations. Opponents note that regulators may face challenges to implement such a subjective set of principles. A lack of clear rules about activities could lead to litigation if financial institutions and consumers alike disagree with how regulators interpreted goals. Opponents of principles-based regulation note that industry participants who support such an approach have also in many cases advocated for bright-line standards and increased clarity in regulation, which may be counter to a principles-based system. The most effective approach may involve both a set of broad underlying principles and some clear technical rules prohibiting specific activities that have been identified as problematic.

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Key issues to be addressed:

- Clarify and update the goals of financial regulation and provide sufficient information on how potentially conflicting goals might be prioritized.
- Determine the appropriate balance of broad principles and specific rules that will result in the most effective and flexible implementation of regulatory goals.

2. *Appropriately comprehensive.* A regulatory system should ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met. As such, activities that pose risks to consumer protection, financial stability, or other goals should be comprehensively regulated, while recognizing that not all activities will require the same level of regulation.

A financial regulatory system should effectively meet the goals of financial regulation, as articulated as part of this process, in a way that is appropriately comprehensive. In doing so, policymakers may want to consider how to ensure that both the breadth and depth of regulation are appropriate and adequate. That is, policymakers and regulators should consider how to make determinations about which activities and products, both new and existing, require some aspect of regulatory involvement to meet regulatory goals, and then make determinations about how extensive such regulation should be. As we have noted, gaps in the current level of federal oversight of mortgage lenders, credit rating agencies, and certain complex financial products such as CDOs and credit default swaps likely have contributed to the current crisis. Congress and regulators may also want to revisit the extent of regulation for entities such as banks that have traditionally fallen within full federal oversight but for which existing regulatory efforts, such as oversight related to risk management and lending standards, have been proven in some cases inadequate by recent events. However, overly restrictive regulation can stifle the financial sectors' ability to innovate and stimulate capital formation and economic growth. Regulators have struggled to balance these competing objectives, and the current crisis appears to reveal that the proper balance was not in place in the regulatory system to date.

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Key issues to be addressed:

- Identify risk-based criteria, such as a product's or institution's potential to harm consumers or create systemic problems, for determining the appropriate level of oversight for financial activities and institutions.
- Identify ways that regulation can provide protection but avoid hampering innovation, capital formation, and economic growth.

3. *Systemwide focus.* A regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it is created.

A regulatory system should focus on risks to the financial system, not just institutions. As noted earlier, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. As we noted earlier in the report, the collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly, once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

Having a single entity responsible for assessing threats to the overall financial system could prevent some of the crises that we have seen in the past. For example, in its *Blueprint for a Modernized Financial Regulatory Structure*, Treasury proposed expanding the responsibilities of the Federal Reserve to create a "market stability regulator" that would have broad authority to gather and disclose appropriate information, collaborate with other regulators on rulemaking, and take corrective action as necessary in the interest of overall financial market stability. Such a regulator could assess the systemic risks that arise at financial institutions, within specific financial sectors, across the nation, and globally. However, policymakers should consider that a potential disadvantage of providing the agency with such broad responsibility for overseeing nonbank entities could be that it may imply an official

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government support or endorsement, such as a government guarantee, of such activities, and thus encourage greater risk taking by these financial institutions and investors.

Regardless of whether a new regulator is created, all regulators under a new system should consider how their activities could better identify and address systemic risks posed by their institutions. As the Federal Reserve Chairman has noted, regulation and supervision of financial institutions is a critical tool for limiting systemic risk. This will require broadening the focus from individual safety and soundness of institutions to a systemwide oversight approach that includes potential systemic risks and weaknesses.

A systemwide focus should also increase attention on how the incentives and constraints created by regulations affects risk taking throughout the business cycle, and what actions regulators can take to anticipate and mitigate such risks. However, as the Federal Reserve Chairman has noted, the more comprehensive the approach, the more technically demanding and costly it would be for regulators and affected institutions.

Key issues to be addressed:

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.
- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.

4. *Flexible and adaptable.* A regulatory system should be adaptable and forward-looking such that regulators can readily adapt to market innovations and changes and include a mechanism for evaluating potential new risks to the system.

A regulatory system should be designed such that regulators can readily adapt to market innovations and changes and include a formal mechanism for evaluating the full potential range of risks of new products and services to the system, market participants, and customers. An effective system could include a mechanism for monitoring market developments—such as broad market changes that introduce systemic risk, or new products and services that may pose more confined risks to particular market segments—to determine the degree, if any, to which regulatory intervention might be required. The rise of a very large market for credit derivatives, while providing benefits to users, also created exposures that

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warranted actions by regulators to rescue large individual participants in this market. While efforts are under way to create risk-reducing clearing mechanisms for this market, a more adaptable and responsive regulatory system might have recognized this need earlier and addressed it sooner. Some industry representatives have suggested that principles-based regulation, as discussed above, would provide such a mechanism. Designing a system to be flexible and proactive also involves determining whether Congress, regulators, or both should make such determinations, and how such an approach should be clarified in laws or regulations.

Important questions also exist about the extent to which financial regulators should actively monitor and, where necessary, approve new financial products and services as they are developed to ensure the least harm from inappropriate products. Some individuals commenting on this framework, including industry representatives, noted that limiting government intervention in new financial activities until it has become clear that a particular activity or market poses a significant risk and therefore warrants intervention may be more appropriate. As with other key policy questions, this may be answered with a combination of both approaches, recognizing that a product approval approach may be appropriate for some innovations with greater potential risk, while other activities may warrant a more reactive approach.

Key issues to be addressed:

- Determine how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such a responsibility.
- Consider how to strike the right balance between overseeing new products as they come onto the market to take action as needed to protect consumers and investors, without unnecessarily hindering innovation.

5. *Efficient and effective.* A regulatory system should provide efficient oversight of financial services by eliminating overlapping federal regulatory missions, where appropriate, and minimizing regulatory burden while effectively achieving the goals of regulation.

A regulatory system should provide for the efficient and effective oversight of financial services. Accomplishing this in a regulatory system involves many considerations. First, an efficient regulatory system is designed to

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accomplish its regulatory goals using the least amount of public resources. In this sense, policymakers must consider the number, organization, and responsibilities of each agency, and eliminate undesirable overlap in agency activities and responsibilities. Determining what is undesirable overlap is a difficult decision in itself. Under the current U.S. system, financial institutions often have several options for how to operate their business and who will be their regulator. For example, a new or existing depository institution can choose among several charter options. Having multiple regulators performing similar functions does allow for these agencies to potentially develop alternative or innovative approaches to regulation separately, with the approach working best becoming known over time. Such proven approaches can then be adopted by the other agencies. On the other hand, this could lead to regulatory arbitrage, in which institutions take advantage of variations in how agencies implement regulatory responsibilities in order to be subject to less scrutiny. Both situations have occurred under our current structure.

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we noted earlier, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted earlier in the report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

One first step to addressing such problems is to seriously consider the need to consolidate depository institution oversight among fewer agencies. Since 1996, we have been recommending that the number of federal agencies with primary responsibilities for bank oversight be reduced. Such a move would result in a system that was more efficient and improve consistency in regulation, another important characteristic of an effective regulatory system. In addition, Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity. We have not studied the issue of an optional federal charter for insurers, but have through the years noted difficulties with efforts to harmonize insurance regulation across states through the NAIC-based structure. The establishment of a federal insurance charter and regulator could help

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alleviate some of these challenges, but such an approach could also have unintended consequences for state regulatory bodies and for insurance firms as well.

Also, given the challenges associated with increasingly complex investment and retail products as discussed earlier, policymakers will need to consider how best to align agency responsibilities to better ensure that consumers and investors are provided with clear, concise, and effective disclosures for all products.

Organizing agencies around regulatory goals as opposed to the existing sector-based regulation may be one way to improve the effectiveness of the system, especially given some of the market developments discussed earlier. Whatever the approach, policymakers should seek to minimize conflict in regulatory goals across regulators, or provide for efficient mechanisms to coordinate in cases where goals inevitably overlap. For example, in some cases, the safety and soundness of an individual institution may have implications for systemic risk, or addressing an unfair or deceptive act or practice at a financial institution may have implications on the institution's safety and soundness by increasing reputational risk. If a regulatory system assigns these goals to different regulators, it will be important to establish mechanisms for them to coordinate.

Proposals to consolidate regulatory agencies for the purpose of promoting efficiency should also take into account any potential trade-offs related to effectiveness. For example, to the extent that policymakers see value in the ability of financial institutions to choose their regulator, consolidating certain agencies may reduce such benefits. Similarly, some individuals have commented that the current system of multiple regulators has led to the development of expertise among agency staff in particular areas of financial market activities that might be threatened if the system were to be consolidated. Finally, policymakers may want to ensure that any transition from the current financial system to a new structure should minimize as best as possible any disruption to the operation of financial markets or risks to the government, especially given the current challenges faced in today's markets and broader economy.

A financial system should also be efficient by minimizing the burden on regulated entities to the extent possible while still achieving regulatory goals. Under our current system, many financial institutions, and especially large institutions that offer services that cross sectors, are subject to supervision by multiple regulators. While steps toward consolidated supervision and designating primary supervisors have helped

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alleviate some of the burden, industry representatives note that many institutions face significant costs as a result of the existing financial regulatory system that could be lessened. Such costs, imposed in an effort to meet certain regulatory goals such as safety and soundness and consumer protection, can run counter to other goals of a financial system by stifling innovation and competitiveness. In addressing this concern, it is also important to consider the potential benefits that might result in some cases from having multiple regulators overseeing an institution. For example, representatives of state banking and other institution regulators, and consumer advocacy organizations, note that concurrent jurisdiction—between two federal regulators or a federal and state regulator—can provide needed checks and balances against individual financial regulators who have not always reacted appropriately and in a timely way to address problems at institutions. They also note that states may move more quickly and more flexibly to respond to activities causing harm to consumers. Some types of concurrent jurisdiction, such as enforcement authority, may be less burdensome to institutions than others, such as ongoing supervision and examination.

Key issues to be addressed:

- Consider the appropriate role of the states in a financial regulatory system and how federal and state roles can be better harmonized.
- Determine and evaluate the advantages and disadvantages of having multiple regulators, including nongovernmental entities such as SROs, share responsibilities for regulatory oversight.
- Identify ways that the U.S. regulatory system can be made more efficient, either through consolidating agencies with similar roles or through minimizing unnecessary regulatory burden.
- Consider carefully how any changes to the financial regulatory system may negatively impact financial market operations and the broader economy, and take steps to minimize such consequences.

6. *Consistent consumer and investor protection.* A regulatory system should include consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements.

A regulatory system should be designed to provide high-quality, effective, and consistent protection for consumers and investors in similar

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situations. In doing so, it is important to recognize important distinctions between retail consumers and more sophisticated consumers such as institutional investors, where appropriate considering the context of the situation. Different disclosures and regulatory protections may be necessary for these different groups. Consumer protection should be viewed from the perspective of the consumer rather than through the various and sometimes divergent perspectives of the multitude of federal regulators that currently have responsibilities in this area.

As discussed earlier, many consumers that received loans in the last few years did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate they had in recent years. In addition, increasing evidence exists that many Americans are lacking in financial literacy, and the expansion of new and more complex products will continue to create challenges in this area. Furthermore, as noted above, regulators with existing authority to better protect consumers did not always exercise that authority effectively. In considering a new regulatory system, policymakers should consider the significant lapses in our regulatory system's focus on consumer protection and ensure that such a focus is prioritized in any reform efforts. For example, policymakers should identify ways to improve upon the existing, largely fragmented, system of regulators that must coordinate to act in these areas. As noted above, this should include serious consideration of whether to consolidate regulatory responsibilities to streamline and improve the effectiveness of consumer protection efforts. Another way that some market observers have argued that consumer protections could be enhanced and harmonized across products is to extend suitability requirements—which require securities brokers making recommendations to customers to have reasonable grounds for believing that the recommendation is suitable for the customer—to mortgage and other products. Additional consideration could also be given to determining whether certain products are simply too complex to be well understood and make judgments about limiting or curtailing their use.

Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer

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protections, including suitability requirements and disclosures across the financial services industry.

- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how products are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.

7. Regulators provided with independence, prominence, authority, and accountability. **A regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals.**

A regulatory system should ensure that any entity responsible for financial regulation is independent from inappropriate influence; has adequate prominence, authority, and resources to carry out and enforce its statutory mission; and is clearly accountable for meeting regulatory goals. With respect to independence, policymakers may want to consider advantages and disadvantages of different approaches to funding agencies, especially to the extent that agencies might face difficulty remaining independent if they are funded by the institutions they regulate. Under the current structure, for example, the Federal Reserve primarily is funded by income earned from U.S. government securities that it has acquired through open market operations and does not assess charges to the institutions it oversees. In contrast, OCC and OTS are funded primarily by assessments on the firms they supervise. Decision makers should consider whether some of these various funding mechanisms are more likely to ensure that a regulator will take action against its regulated institutions without regard to the potential impact on its own funding.

With respect to prominence, each regulator must receive appropriate attention and support from top government officials. Inadequate prominence in government may make it difficult for a regulator to raise safety and soundness or other concerns to Congress and the administration in a timely manner. Mere knowledge of a deteriorating situation would be insufficient if a regulator were unable to persuade Congress and the administration to take timely corrective action. This problem would be exacerbated if a regulated institution had more political clout and prominence than its regulator because the institution could potentially block action from being taken.

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In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, as noted earlier, in a 2007 report we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.[74] It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct their work effectively. A regulatory system should also include adequate checks and balances to ensure the appropriate use of agency authorities. With respect to accountability, policymakers may also want to consider different governance structures at agencies—the current system includes a combination of agency heads and independent boards or commissions—and how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals.

Key issues to be addressed:

- Determine how to structure and fund agencies to ensure each has adequate independence, prominence, tools, authority and accountability.
- Consider how to provide an appropriate level of authority to an agency while ensuring that it appropriately implements its mission without abusing its authority.
- Ensure that the regulatory system includes effective mechanisms for holding regulators accountable.

8. *Consistent financial oversight.* A regulatory system should ensure that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally.

A regulatory system should ensure that similar institutions, products, and services posing similar risks are subject to consistent regulation, oversight, and transparency. Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very

[74]GAO-07-154.

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different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.

Streamlining the regulation of similar products across sectors could also help prepare the United States for challenges that may result from increased globalization and potential harmonization in regulatory standards. Such efforts are under way in other jurisdictions. For example, at a November 2008 summit in the United States, the Group of 20 countries pledged to strengthen their regulatory regimes and ensure that all financial markets, products, and participants are consistently regulated or subject to oversight, as appropriate to their circumstances. Similarly, a working group in the European Union is slated by the spring of 2009 to propose ways to strengthen European supervisory arrangements, including addressing how their supervisors should cooperate with other major jurisdictions to help safeguard financial stability globally. Promoting consistency in regulation of similar products should be done in a way that does not sacrifice the quality of regulatory oversight.

As we noted in a 2004 report, different regulatory treatment of bank and financial holding companies, consolidated supervised entities, and other holding companies may not provide a basis for consistent oversight of their consolidated risk management strategies, guarantee competitive neutrality, or contribute to better oversight of systemic risk. Recent events further underscore the limitations brought about when there is a lack of consistency in oversight of large financial institutions. As such, Congress and regulators will need to seriously consider how best to consolidate responsibilities for oversight of large financial conglomerates as part of any reform effort.

Key issues to be addressed:

- Identify institutions and products and services that pose similar risks.
- Determine the level of consolidation necessary to streamline financial regulation activities across the financial services industry.
- Consider the extent to which activities need to be coordinated internationally.

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9. *Minimal taxpayer exposure.* A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. Policymakers should consider identifying the best safeguards and assignment of responsibilities for responding to situations where taxpayers face significant exposures, and should consider providing clear guidelines when regulatory intervention is appropriate. While an ideal system would allow firms to fail without negatively affecting other firms—and therefore avoid any moral hazard that may result—policymakers and regulators must consider the realities of today's financial system. In some cases, the immediate use of public funds to prevent the failure of a critically important financial institution may be a worthwhile use of such funds if it ultimately serves to prevent a systemic crisis that would result in much greater use of public funds in the long run. However, an effective regulatory system that incorporates the characteristics noted above, especially by ensuring a systemwide focus, should be better equipped to identify and mitigate problems before it become necessary to make decisions about whether to let a financial institution fail.

An effective financial regulatory system should also strive to minimize systemic risks resulting from interrelationships between firms and limitations in market infrastructures that prevent the orderly unwinding of firms that fail. Another important consideration in minimizing taxpayer exposure is to ensure that financial institutions provided with a government guarantee that could result in taxpayer exposure are also subject to an appropriate level of regulatory oversight to fulfill the responsibilities discussed above.

Key issues to be addressed:

- Identify safeguards that are most appropriate to prevent systemic crises while minimizing moral hazard.
- Consider how a financial system can most effectively minimize taxpayer exposure to losses related to financial instability.

Finally, although significant changes may be required to modernize the U.S. financial regulatory system, policymakers should consider carefully how best to implement the changes in such a way that the transition to a new structure does not hamper the functioning of the financial markets,

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individual financial institutions' ability to conduct their activities, and consumers' ability to access needed services. For example, if the changes require regulators or institutions to make systems changes, file registrations, or other activities that could require extensive time to complete, the changes could be implemented in phases with specific target dates around which the affected entities could formulate plans.

In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.[75] Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

Comments from Agencies and Other Organizations, and Our Evaluation

We provided the opportunity to review and comment on a draft of this report to representatives of 29 agencies and other organizations, including federal and state financial regulatory agencies, consumer advocacy groups, and financial service industry trade associations. A complete list of organizations that reviewed the draft is included in appendix II. All reviewers provided valuable input that was used in finalizing this report. In general, reviewers commented that the report represented a high-quality and thorough review of issues related to regulatory reform. We made changes throughout the report to increase its precision and clarity and to provide additional detail. For example, the Federal Reserve provided comments indicating that our report should emphasize that the traditional goals of regulation that we described in the background section are incomplete unless their ultimate purpose is considered, which is to promote the long-term growth, stability, and welfare of the United States. As a result, we expanded the discussion of our framework element concerning the need to have clearly defined regulatory goals to emphasize

[75]See GAO, *Homeland Security: Critical Design and Implementation Issues*, GAO-02-957T. (Washington, D.C.: July 17, 2002).

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that policymakers will need to ensure that such regulation is balanced with other national goals, including facilitating capital raising and fostering innovation.

In addition, we received formal written responses from the American Bankers Association, the American Council of Life Insurers, the Conference of State Bank Supervisors, Consumers Union, the Credit Union National Association, the Federal Deposit Insurance Corporation, the Mortgage Bankers Association, and the National Association of Federal Credit Unions, and a joint letter from the Center for Responsible Lending, the National Consumer Law Center, and U.S. PIRG; all formal written responses are included as appendixes to this report.

Among the letters we received, various commenters raised additional issues regarding consumer protection and risky products. For example, in a joint letter, the Center for Responsible Lending, the National Consumer Law Center, and the U.S. PIRG noted that the best way to avoid systemic risk is to address problems that exist at the level of individual consumer transactions, before they pose a threat to the system as a whole. They also noted that although most of the subprime lending was done by nonbank lenders, overly aggressive practices for other loan types and among other lenders also contributed to the current crisis. In addition, they noted that to effectively protect consumers, the regulatory system must prohibit unsustainable lending and that disclosures and financial literacy are not enough. The letter from FDIC agreed that effective reform of the U.S. financial regulatory system would help avoid a recurrence of the economic and financial problems we are now experiencing. It also noted that irresponsible lending practices were not consistent with sound banking practices. FDIC's letter also notes that the regulatory structure collectively permitted excessive levels of leverage in the nonbank financial system and that statutory mandates that address consumer protection and aggressive lending practices and leverage among firms would be equally important for improving regulation as would changing regulatory structure. In a letter from Consumers Union, that group urged that consumer protection be given equal priority as safety and soundness and that regulators act more promptly to address emerging risks rather than waiting until a problem has become national in scope. The letter indicates that Consumers Union supports an independent federal consumer protection agency for financial services and the ability of states to also develop and enforce consumer protections. We made changes in response to many of these comments. For example, we enhanced our discussion of weaknesses in regulators' efforts to oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system, and

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we made changes to the framework to emphasize the importance of consumer protection.

Several of the letters addressed issues regarding potential consolidation of regulatory agencies and the role of federal and state regulation. The letter from the American Bankers Association said that the current system of bank regulation and oversight has many advantages and that any reform efforts should build on those advantages. The letter also noted that there are benefits to having multiple federal regulators, as well as a dual banking system. The letter from the Conference of State Bank Supervisors agreed with our report that the U.S. regulatory system is complex and clearly has gaps, but cautioned that consolidating regulation and making decisions that could indirectly result in greater industry consolidation could exacerbate problems. The letter also indicates concern that our report does not fully acknowledge the importance of creating an environment that promotes a diverse industry to serve the nation's diverse communities and prevents concentration of economic power in a handful of institutions. Our report does discuss the benefits of state regulation of financial institutions, but we did not address the various types of state institutions because we focused mainly on the federal role over our markets. In the past, our work has acknowledged the dual banking system has benefits and that concentration in markets can have disadvantages. The Conference of State Bank Supervisors letter also notes that state efforts to respond to consumer abuses were stymied by federal pre-emption and that a regulatory structure should preserve checks and balances, avoid concentrations of power, and be more locally responsive. In response to this letter, we also added information about the enactment of the Secure and Fair Enforcement for Mortgage Licensing Act, as part of the Housing and Economic Recovery Act, which requires enhanced licensing and registration of mortgage brokers.

The letter from the National Association of Federal Credit Unions urged that an independent regulator for credit unions be retained because of the distinctive characteristics of federal credit unions. A letter from the Credit Union National Association also strongly opposes combining the credit union regulator or its insurance function with another agency. The letter from the Mortgage Bankers Association urges that a federal standard for mortgage lending be developed to provide greater uniformity than the currently diffuse set of state laws. They also supported consideration of federal regulation of independent mortgage bankers and mortgage brokers as a way of improving uniformity and effectiveness of the regulation of these entities. A letter from the American Council of Life Insurers noted that the lack of a federal insurance regulatory office provides for uneven

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consumer protections and policy availability nationwide and hampers the country's ability to negotiate internationally on insurance industry issues, and urged that we include a discussion of the need to consider a greater federal role in the regulation of insurance. As a result, in the section where we discuss the need for efficient and effective regulation we noted that harmonizing insurance regulation across states has been difficult, and that Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity.

We are sending copies of this report to interested congressional committees and members. In addition, we are sending copies to the federal financial regulatory agencies and associations representing state financial regulators, financial industry participants, and consumers, as well as to the President and Vice President, the President-Elect and Vice President-Elect, and other interested parties. The report also is available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix XII.



Gene L. Dodaro
Acting Comptroller General of the United States

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List of Congressional Addressees

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Joseph I. Lieberman
Chairman
The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Edolphus Towns
Chairman
The Honorable Darrell E. Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

The Honorable Richard J. Durbin
The Honorable Tim Johnson
The Honorable Jack Reed
United States Senate

The Honorable Judy Biggert
The Honorable Paul E. Kanjorski
The Honorable Carolyn B. Maloney
The Honorable José E. Serrano
House of Representatives

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Appendix I: Scope and Methodology

Our report objectives were to (1) describe the origins of the current financial regulatory system, (2) describe various market developments and changes that have raised challenges for the current system, and (3) present an evaluation framework that can be used by Congress and others to craft or evaluate potential regulatory reform efforts going forward.

To address all of these objectives, we synthesized existing GAO work on challenges to the U.S. financial regulatory structure and on criteria for developing and strengthening effective regulatory structures. These reports are referenced in footnotes in this report and noted in the Related GAO Products appendix. In particular, we relied extensively on our recent body of work examining the financial regulatory structure, culminating in reports issued in 2004 and 2007.[1] We also reviewed existing studies, government documents, and other research for illustrations of how current and past financial market events have revealed limitations in our existing regulatory system and suggestions for regulatory reform.

In addition, to gather input on challenges with the existing system and important considerations in evaluating reforms, we interviewed several key individuals with broad and substantial knowledge about the U.S. financial regulatory system—including a former Chairman of the Board of Governors of the Federal Reserve System (Federal Reserve), a former high-level executive at a major investment bank that had also served in various regulatory agencies, and an international financial organization official that also served in various regulatory agencies. We selected these individuals from a group of notable officials, academics, legal scholars, and others we identified as part of this and other GAO work, including a 2007 expert panel on financial regulatory structure. We selected individuals to interview in an effort to gather government, industry, and academic perspectives, including on international issues. In some cases, due largely to the market turmoil at the time of our study, we were unable to or chose not to reach out to certain individuals, but took steps to ensure that we selected other individuals that would meet our criteria.

To develop the evaluation framework, we also convened a series of three forums in which we gathered comments on a preliminary draft of our framework from a wide range of representatives of federal and state

[1]GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004); and *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007).

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financial regulatory agencies, financial industry associations and institutions, and consumer advocacy organizations. In particular, at a forum held on August 19, 2008, we gathered comments from representatives of financial industry associations and institutions, including the American Bankers Association, the American Council of Life Insurers, The Clearing House, Columbia Bank, the Independent Community Bankers of America, The Financial Services Roundtable, Fulton Financial Corporation, the Futures Industry Association, the Managed Funds Association, the Mortgage Bankers Association, the National Association of Federal Credit Unions, the Securities Industry and Financial Markets Association, and the U.S. Chamber of Commerce. We worked closely with representatives at the American Bankers Association—which hosted the forum at its Washington, D.C., headquarters—to identify a comprehensive and representative group of industry associations and institutions.

At a forum held on August 27, 2008, we gathered comments from representatives of consumer advocacy organizations, including the Center for Responsible Lending, the Consumer Federation of America, the Consumers Union, the National Consumer Law Center, and the U.S. PIRG. We invited a comprehensive list of consumer advocacy organization representatives—compiled based on extensive dealings with these groups from current and past work—to participate in this forum and hosted it at GAO headquarters in Washington, D.C.

At a forum held on August 28, 2008, we gathered comments from representatives of federal and state banking, securities, futures, insurance and housing regulatory oversight agencies, including the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Department of the Treasury, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Federal Reserve, the Financial Industry Regulatory Authority, the National Association of Insurance Commissioners, the National Credit Union Administration, the North American Securities Administrators Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Public Company Accounting Oversight Board, and the Securities and Exchange Commission. We worked closely with officials at the Federal Reserve—which hosted the forum at its Washington, D.C., headquarters—to identify a comprehensive and representative group of federal and state financial regulatory agencies.

We conducted this work from April 2008 to December 2008 in accordance with generally accepted government auditing standards. Those standards

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require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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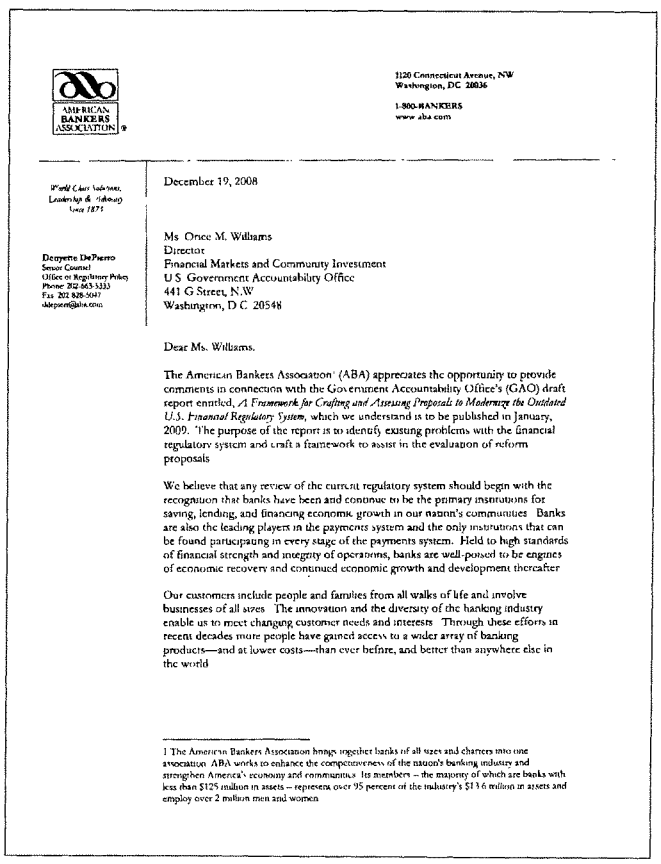
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Appendix II: Agencies and Other Organizations That Reviewed the Draft Report

American Bankers Association
American Council of Life Insurers
Center for Responsible Lending
Commodity Futures Trading Commission
Conference of State Bank Supervisors
Consumer Federation of America
Consumers Union
Credit Union National Association
Department of the Treasury
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Federal Reserve
Financial Industry Regulatory Authority
Financial Services Roundtable
Futures Industry Association
Independent Community Bankers of America
International Swaps and Derivates Association
Mortgage Bankers Association
National Association of Federal Credit Unions
National Association of Insurance Commissioners
National Consumer Law Center
National Credit Union Administration
National Futures Association
Office of the Comptroller of the Currency
Office of Thrift Supervision
Public Company Accounting Oversight Board
Securities and Exchange Commission
Securities Industry and Financial Markets Association
U.S. PIRG

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Appendix III: Comments from the American Bankers Association



AMERICAN BANKERS ASSOCIATION

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December 19, 2008

Ms Orice M. Williams
Director
Financial Markets and Community Investment
U S Government Accountability Office
441 G Street, N.W
Washington, D C 20548

Dear Ms. Williams,

The American Bankers Association[1] (ABA) appreciates the opportunity to provide comments in connection with the Government Accountability Office's (GAO) draft report entitled, *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, which we understand is to be published in January, 2009. The purpose of the report is to identify existing problems with the financial regulatory system and craft a framework to assist in the evaluation of reform proposals

We believe that any review of the current regulatory system should begin with the recognition that banks have been and continue to be the primary institutions for saving, lending, and financing economic growth in our nation's communities Banks are also the leading players in the payments system and the only institutions that can be found participating in every stage of the payments system. Held to high standards of financial strength and integrity of operations, banks are well-poised to be engines of economic recovery and continued economic growth and development thereafter

Our customers include people and families from all walks of life and involve businesses of all sizes The innovation and the diversity of the banking industry enable us to meet changing customer needs and interests Through these efforts in recent decades more people have gained access to a wider array of banking products—and at lower costs—than ever before, and better than anywhere else in the world

1 The American Bankers Association brings together banks of all sizes and charters into one association ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13 6 trillion in assets and employ over 2 million men and women

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We support a regulatory program that fosters a climate in which we can build on these accomplishments and continue our progress in providing more and better services to more people and businesses at lower costs. With that in mind, we offer the following observations about ways in which changes to the current system could achieve these objectives

The central objective of regulatory reform efforts should be to enhance banks' ability to meet the needs of their customers This objective has several facets First, regulation needs to foster safe and sound operations. Second, it must provide appropriate consumer protections Third, it needs to promote competition. And fourth, it must foster innovation and facilitate banks' ability to meet changing customer needs These facets, while distinct, are wholly compatible. A financial institution will best be able to achieve its business objectives by responsibly managing its risks; by providing a full range of products and services to all customers who can responsibly manage *their* risks, and by competing against others based on price, product quality, reputation, and other customer interests, not by undermining standards of integrity We believe it is incumbent upon policy makers to create the legal framework that supports these goals

Any regulatory reform effort must focus on solving the problems that caused the current market turmoil This necessarily entails identifying what those problems are so that responses can be tailored accordingly. A business model that combines activities that are financial in nature and thereby draws from a diversified revenue mix has shown to be a solution to, and not a part of, the current problems. Thus reform efforts should facilitate banks offering a broad range of financial products and services Conversely, reform efforts should be careful not merely to impose new regulations on the banking sector, which did not cause the crisis and which continues to provide credit; rather it should remove unnecessary regulations that impede sound lending and efficient operations

The current system of bank regulation and oversight has many advantages, and we believe any reform efforts should build on those advantages As the recent rush by non-bank actors to obtain bank charters has demonstrated, bank regulation and supervision has proven to be the most durable method to minimize risks to safety and soundness Moreover, it provides a useful check against any one regulator neglecting its duties, becoming too calcified for an ever-changing financial marketplace, growing overly bureaucratic and ineffective, or otherwise imposing regulatory conditions inconsistent with the ability of financial firms to serve their customers. Thus, the ABA supports the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and the Office of Thrift Supervision with regard to their diverse supervision and oversight responsibilities within the U S banking system

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Just as there is a benefit in having multiple federal regulators, so too is there a benefit in having a dual banking system. States have for years operated as incubators for new products and services, such as NOW accounts and adjustable rate mortgages The dual banking system has proven vital to the continued evolution of the U.S banking. Close coordination between federal bank regulators and state banking commissioners within the Federal Financial Institutions Examination Council (FFIEC) as well as during joint bank examinations is a dynamic element of the dual banking system, resulting in a system of complementary supervision

Recent economic turmoil has drawn attention to the need for a regulator with explicit jurisdiction to manage systemic risk The primary responsibility of systemic risk regulation should be protecting the economy from major shocks and working with bank supervisors to avoid pro-cyclical directives within the supervisory process The systemic risk regulator would gather information, monitor exposures throughout the system and take action in concert with domestic and international supervisors to minimize risks to the economy For maximum effectiveness and ease of implementation, systemic risk regulation should rely on existing regulatory structures and restrict its oversight to a limited number of large market participants, both bank and non-bank

There clearly is a need for better supervision and regulation of many non-bank actors, such as mortgage banks and brokers that are not affiliated with an insured depository institution. Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank like services while operating under substandard or non-existent guidelines for safety and soundness. Lesser-regulated companies and individuals participating in bank-like activities or offering bank-like products and services should be subject to bank-like regulation and capital requirements Regulatory reform should tackle these issues and bring appropriate oversight to inadequately or ineffectively regulated financial products and services.

This should be done within the context of agencies that have the authority and responsibility to supervise all aspects of an institution's activities Safety and soundness issues and consumer protection are closely linked for banks and should be supervised as such Treating consumers unfairly is inconsistent with safe and sound operations; so, too, is attempting to insulate consumers from any risk Well-run institutions keep both facets in mind, and their regulators should as well. This argues in favor of continuing to place responsibility for both consumer protection and safety and soundness with the banking agencies.

It also should be done in a manner that preserves the independence of the Federal Reserve Board (Board) and keeps the Board's primary focus on the conduct of monetary policy Any expansion of the Board's authority to serve as the systemic risk regulator should be made only if such authority would not create conflicts of interest for the Board or otherwise compromise its ability to carry out its responsibilities for monetary policy

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Any regulatory restructuring effort must recognize the benefits of charter choice. A robust banking sector requires participants of all sizes and business models, including community banks, development banks, and niche-focused financial institutions as well as regional, national, and international banks. Federal and state bank charter alternatives, a broad range of business models, as well as choice of ownership structure (encompassing S corporations, limited liability corporations, mutual ownership, and other forms of publicly-traded and privately-held banks) promotes responsiveness to changing customer needs, consumer preferences, and economic conditions. Only a diverse, well-regulated banking system can bring sustainable increases in homeownership and community development that are essential to economic recovery.

This diversity is not well-served by a system that treats any financial institution as if it were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole. Clear actions strengthening the competitive position of all banks are needed to address and ameliorate the negative effect on the majority of financial institutions when a select few are designated as too big to fail. Moreover, financial regulators should develop a program to identify, monitor, and respond effectively to market developments arising to the perception of an institution as too big or too complex to fail—particularly in times of financial stress. The ad hoc approach used in the resolution of Lehman Brothers and Bear Sterns is inadequate. Specific authorities and programs must be developed to manage the orderly transition or resolution of any systemically significant financial institution, bank or non-bank.

Any reform effort also must address issues in our accounting rules that create a pro-cyclical downward drag on the financial sector and the economy as a whole. Accounting should be a reflection of economic reality, not a driver. Reforms to accounting standards should make the standard setting process accountable to the market and implement standards that consider the real-world effects of the rules. Rules governing loan-loss reserves and fair value accounting should minimize pro-cyclical effects that reinforce economic highs and lows. A reformed accounting system would recognize that functioning accounting rules are essential to minimizing systemic risk and fostering economic growth.

Thank you for the opportunity to comment on this proposal. Should you have any questions, please contact the undersigned at 202-663-5333 or ddepierro@aba.com.

Sincerely,

Denyette DePierro

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Appendix IV: Comments from the American Council of Life Insurers

ACLI
American Council of Life Insurers

Julie A. Spiezio
Senior Vice President, Insurance Regulation & Deputy General Counsel

December 15, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548
williamso@gao.gov

RE: Draft Report on Reforming the Financial Regulatory System

Dear Ms. Williams:

These comments are submitted on behalf of the American Council of Life Insurers (ACLI). The ACLI is a national trade association with 353 member companies that account for 93 percent of the industry's total assets, 93 percent of U.S life insurance premiums and 95 percent of U.S. annuity considerations. We appreciate being given an opportunity to comment on the draft report.

At GAO's invitation, ACLI staff undertook a brief review of the draft report at GAO headquarters early last week. Speaking from an insurance industry perspective, we were surprised that the draft report did not include discussion of the need for insurance regulatory reform as part of the broader financial services industry reform effort. We believe this is an important oversight and one that should be addressed before the final report is issued by the GAO.

Currently there is no insurance expertise in the federal government. Prior to the crisis that has beset the financial service industry since September of this year, this fact was proving to be a costly problem for American consumers and insurers alike. A regulatory system that provides for uneven consumer protections and policy availability nationwide is not compatible with the economic model of the 21st century. In addition, the lack of a federal insurance regulatory office prevents the United States from adequately addressing its citizens' needs in international trade negotiations and treaty developments involving insurance industry issues. These issues alone warrant discussion of the need for a federal role in insurance regulation via the availability of an optional federal insurance charter (OFC).

The economic crisis has only served to underscore this need The crisis has highlighted for policymakers and the general public alike that insurers play a systemic role in our economy, both nationally and internationally. And today, after all that has taken place over the past few months, both the executive and legislative branches of the federal government remain handicapped in their ability to completely understand and respond to the underlying insurance issues that are part of the financial crisis because they lack any insurance industry regulatory expertise.

These facts make the lack of reference to the issue of insurance regulatory reform in the draft GAO report just that much more puzzling. The report directly addresses the need for the federal government

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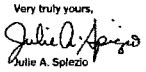
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to assume some regulatory responsibility over other areas of the financial services industry where it currently lacks such authority (e.g., hedge funds), but remains conspicuously silent on the insurance regulatory reform/OFC issue. We feel this is not simply an oversight, but is a lost opportunity to help Congress in its effort to effectively reform and modernize the whole of financial services industry regulation moving forward.

For all of these reasons, we respectfully request that prior to the final publication of this GAO report it be revised to include discussion of the need for insurance regulatory reform. It is our opinion that releasing the report without such a revision will render the report incomplete and therefore of less value to both the Congress and the public at large then it otherwise might be.

Thank you again for this opportunity to comment on the draft report. Please feel free to contact me directly if you have any questions or would like to discuss this issue further.

Very truly yours,



Julie A. Splezio

Cc: Randy Fasnacht
Cody Goebel

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Appendix V: Comments from the Conference of State Bank Supervisors

December 17, 2008

Orice M Williams
Director
Financial Markets and Community Investment
U S Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms Williams

Thank you for the opportunity to submit a second written comment in response to the GAO's upcoming report on the financial regulatory framework of the United States

The Conference of State Bank Supervisors (CSBS) recognizes the current regulatory structure at both the state and federal level is sometimes complex for the industry, regulators, consumers, and policymakers to navigate As financial institutions and service providers increase in size, complexity, and operations, our regulatory system must reflect this evolution The current economic stresses have also shown that our financial regulatory system must better address the interconnected risks of the capital markets and our banking system

CSBS is committed to working with the GAO, our federal counterparts, Congress, industry associations, and consumer advocates to further the development of a fair and efficient regulatory system that provides sufficient consumer protection and serves the interests of financial institutions and financial service providers, while ultimately strengthening the U S economy as a whole

We believe that changes are needed in both regulation and the way our regulatory structure functions to better respond to consumer needs and address systemic risks and market integrity We are very concerned, however, that federal policy that addresses nationwide and global regulatory business models continues to threaten—or perhaps eliminate—the greatest strengths of our system Specifically, we see policies that promote the needs of the very largest financial institutions at the expense of consumers, important federal checks and balances and diversity of banking and other financial institutions that are critical to our state economies

The current financial regulatory structure allows for a diverse universe of financial institutions of varying sizes While the financial industry continues to consolidate at a rapid pace, there are still well over 8,000 financial institutions operating within the United

CONFERENCE OF STATE BANK SUPERVISORS
1155 Connecticut Ave , NW, 5th Floor • Washington DC 20036-4306 • (202) 296-2840 • Fax (202) 296-1928

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States, some of which are as small as $1 million in assets Obviously, our nation's largest money center banks play a critical role in the economy However, even the smallest bank in the country is absolutely critical to the economic health of the community in which it operates

The complexity of the system is presented as a major source of the current financialcrisis While there are clearly gaps in our regulatory system and the system is undeniably complex, CSBS has observed that the greater failing of the system has been one of insufficient political and regulatory will, primarily at the federal level We believe that decisions to consolidate regulation do not fix, but rather exacerbate this problem Moreover, CSBS is deeply concerned that the GAO study does not fully appreciate the importance of creating an environment that promotes a diverse industry which serves our nation's diverse communities and avoids a concentration of economic and political power in a handful of institutions

Specifically, we are offering the following comments to the elements of a successful supervisory framework

Clearly Defined Regulatory Goals
Generally, we agree with the GAO's goals of a regulatory system that ensures adequate consumer protections, ensures the integrity and fairness of markets, monitors the safety and soundness of institutions, and acts to ensure the stability of the overall financial system We disagree, however, with the GAO's claim that the safety and soundness goal is necessarily in direct conflict with the goal of consumer protection It has been the experience of state regulators that the very opposite can be true Indeed, consumer protection should be recognized as integral to safety and soundness of financial institutions and service providers The health of a financial institution ultimately is connected to the health of its customers However, we have observed that federal regulators, without the checks and balances of more locally responsive state regulators or state law enforcement do not always give fair weight to consumer issues or have the perspective to understand consumer issues We consider this a significant weaknessof the current system Federal preemption of state law and state law enforcement by the Office of the Comptroller of the Currency and the Office of Thrift Supervision has resulted in less responsive consumer protections and institutions that are much less responsive to needs of consumers in our states

Appropriately Comprehensive
CSBS disagrees that federal regulators were unable to identify the risks to the financial system because they did not have the necessary scope of oversight As previously noted, we believe it was a failure of regulatory will and a philosophy of self-regulating markets that allowed for risks to develop CSBS strongly believes a "comprehensive" system of regulation should not be construed as a consolidated regime under one single regulator Instead, "comprehensive" should describe a regulatory system that is able to adequately supervise a broad, diverse, and dynamic financial industry We believe that the checks and balances of the dual system of federal and state supervision are more likely to result in

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comprehensive and meaningful coverage of the industry. From a safety and soundness perspective and from a consumer protection standpoint, the public is better served by a coordinated regulatory network that benefits from both the federal and state perspectives We believe the Federal Financial Institutions Examination Council (FFIEC) could be much better utilized to accomplish this approach

Systemwide Focus
The GAO report states "a regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it was created " CSBS agrees with this assessment Our current crisis has shown us that our regulatory structure was incapable of effectively managing and regulating the nation's largest institutions CSBS believes the solution, however, is not to expand the federal government bureaucracy by creating a new super regulator Instead, we should enhance coordination and cooperation among the federal government and the states We believe regulators must pool resources and expertise to better manage systemic risk The FFIEC provides a vehicle for working towards this goal of seamless federal and state cooperative supervision

In addition, CSBS provides significant coordination among the states as well as with federal regulators This coordinating role reached new levels when Congress adopted the Riegle-Neil Act to allow for interstate banking and branching The states, through CSBS, quickly followed suit by developing the Nationwide Cooperative Agreement and the State-Federal Supervisory Agreement for the supervision of multi-state banks Most recently, the states launched the Nationwide Mortgage Licensing System (NMLS) and a nationwide protocol for mortgage supervision Further, the NMLS is the foundation for the recently enacted Secure and Fair Enforcement for Mortgage Licensing Act of 2008, or the S A F E Act The S A F E Act establishes minimum mortgage licensing standards and a coordinated network of state and federal mortgage supervision

Flexible and Adaptable
CSBS agrees that a regulatory system should be adaptable and forward-looking so that regulators can readily adapt to market innovations and chances to include a mechanism for evaluating potential new risks to the system In fact, this is one of the greatest strengths of the state system The traditional dynamic of the dual-banking system of regulation has been that the states experiment with new products, services, and practices that, upon successful implementation, Congress later enacts on a nationwide basis In addition, state bank examiners are often the first to identify and address economic problems Often, states are the first responders to almost any problem in the financial system The states can—and do—respond to these problems much more quickly than the federal government as evidenced by escalating state responses to the excesses and abuses of mortgage lending over the past decade Unfortunately, the federal response was to thwart rather than encourage these policy responses

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Efficient and Effective

In the report, GAO asserts that a system should provide for efficient and effective oversight by eliminating overlapping federal regulatory missions and minimizing regulatory burden CSBS believes efficiency must not be achieved at the cost of protecting consumers, providing for a competitive industry that serves all communities or maintaining the safety and soundness of financial institutions. We recognize that our regulatory structure is complex and may not be as efficient as some in the industry would prefer There is undoubtedly a need for improved coordination and cooperation among functional regulators However, this efficiency must not be met through the haphazard consolidation or destruction of supervisory agencies and authorities CSBS strongly believes that it is more important to preserve a regulatory framework with checks and balances among and between regulators This overlap does not need to be a negative characteristic of our system Instead, it has most often offered additional protection for our consumers and institutions We believe that the weakening of these overlays in recent years weakened our system and contributed to the current crisis

In addition, we should consider how "efficient" is defined Efficient does not inherently mean effective Our ideal regulatory structure should balance what is efficient for large and small institutions as well as what is efficient for consumers and our economy While a centralized and consolidated regulatory system may look efficient on paper or benefitour largest institutions, the outcomes may be inflexible and be geared solely at the largest banks at the expense of the small community institutions, the consumer or our diverse economy

Consistent Consumer and Investor Protection

The states have long been regarded as leaders in the consumer protection arena This is an area where the model of states acting as laboratories of innovation is clearly working State authorities often discover troubling practices, trends, or warning signs before the federal agencies can identify these emerging concerns State authorities and legislature then are able to respond quickly to protect consumers Ultimately, Congress and federal regulators can then rely on state experience to develop uniform and nationwide standards or best practices Ultimately, we believe the federal government is simply not able to respond quickly enough to emerging threats and consumer protection issues State authorities have also been frustrated by federal preemption of state consumer protection laws If Congress were to act to repeal or more clearly limit these preemptions, states would be able to more effectively and consistently enforce consumer protection laws

CSBS also agrees that there were significant loopholes and unequal regulation and examination of the mortgage industry In fact, the states led the way to address these regulatory gaps However, in describing where subprime lending occurred, we believe the report should acknowledge the fact that subprime lending took place in nearly equal parts between nonbank lenders and institutions subject to federal bank regulation Federal regulation of operating subsidiaries has been inconsistent at best and nonexistent at worst As acknowledged in the report, affiliate regulation for consumer compliancesimply did

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not exist at the federal level until a recent pilot project led by the Federal Reserve was initiated

The report also fails to acknowledge the very significant reforms of mortgage regulation adopted by Congress under the S A F E Act or the major efforts the states have engaged in to regulate the nonbank mortgage lenders and originators

Regulators Provided with Independence, Prominence, Authority, and Accountability
The dual-banking system helps preserve both regulator independence and accountability The state system of chartering, with an independent primary federal regulator probably serves as the best model for this goal

Consistent Financial Oversight
Consistency in regulation is important, but our financial system must also be flexible enough to allow our diverse institutions all to flourish The diversity of our nation's banking system has created the most dynamic and powerful economy in the world, regardless of the current problems we are experiencing The strength at the core of our banking system is that it is comprised of thousands of financial intutions of vastly different sizes Even as our largest banks are struggling to survive, the vast majority of community banks remains strong and continues to provide financial services to their local citizens It is vital that a one-size-fits-all regulatory system does not adversely affect the industry by putting smaller banks at a competitive disadvantage with larger, more complex institutions

It is our belief that the report should acknowledge the role of federal preemption of state consumer protections and the lack of responsiveness of federal law and regulation to mortgage lending and consumer protection issues For example, the states began responding in 1999 to circumventions of HOEPA and consumer abuses related to subprime lending Nine years later and two years into a nationwide subprime crisis and Congress has not yet been able to adopt a predatory lending law We believe that some industry advocates have pushed for preempton to prevent the states from being able to develop legislative and regulatory models for consumer protectionand because they have been successful in thwarting legislation and significant regulation at the federal level

Minimal Taxpayer Exposure
CSBS strongly agrees that a regulatory system should have adequate safeguards hat allow financial institution failures to occur while limiting taxpayers' exposure to financial risk Part of this process must be to prevent institutions from becoming "too big to fail," "too systemic to fail," or simply too big to regulate Specifically, the federal government must have regulatory tools in place to manage the orderly failure of the largest institutions rather than continuing to prop up failed systemic institutions

CSBS Priociples of Regulatory Reform
While numerous proposals will be advanced to overhaul the financial regulatory system, CSBS believes the structure of the regulatory system should

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1 Usher in a new era of cooperative federalism, recognizing the rights of states to protect consumers and reaffirming the state role in chartering and supervising financial institutions
2 Foster supervision that is tailored to the size, scope, and complexity of the institution and the risk they pose to the financial system
3 Assure the promulgation and enforcement of consumer protection standards that are applicable to both state and nationally chartered financial institutions and are enforceable by locally-responsive state officials against all such institutions
4 Encourage a diverse universe of financial institutions as a method of reducing risk to the system, encouraging competition, furthering innovation, insuring access to financial markets, and promoting efficient allocation of credit
5 Support community and regional banks, which provide relationship lending and fuel local economic development
6 Require financial institutions that are recipients of governmental protection or pose systemic risk to be subject to safety and soundness and consumer protection oversight

The states, through CSBS and the State Liaison Committee's involvement on the FFIEC, will be part of any solution to regulatory restructuring or our current economic conditon We want to ensure consumers are protected, and preserve the viability of both the federal and state charter to ensure the success of our dual-banking system and our economyas a whole

CSBS believes there is significant work to be done on this issue, and we commend the GAO for undertaking this report

Best regards,

John W Ryan
Executive Vice President

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Appendix VI: Comments from Consumers Union

Consumers Union

Via Electronic Mail

December 16, 2008

Ms Orice M Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Re. GAO Report on Reforming the Financial Regulatory System

Dear Ms. Williams,

Consumers Union, the nonprofit publisher of *Consumer Reports*, is deeply interested in creating a more effective structure for the regulation of financial institutions and other participants in the financial markets. Financial regulation must be designed to protect individuals as consumers of credit and deposit services, as investors, and as taxpayers.

The spark for the financial crisis was unsuitable, poorly underwritten loans being sold to individual homeowners The risk was amplified by widespread sale of financial instruments based on those mortgages The resulting crisis of confidence has led to reduced credibility for the U.S. financial system, gridlocked credit markets, loss of equity for homeowners who accepted subprime mortgages and for their neighbors who did not, empty houses and reduced property tax revenue.

Any future financial regulatory structure must include active federal and state oversight, a priority on consumer protection, steps to make the pricing and features of financial products less complex, and more accountability by financial entities at each step of a financial transaction.

1. Regulators must be required to proactively monitor new products and practices to address dangers before they spread. Financial system regulators must identify, evaluate, and mitigate emerging risks both to the financial system and to individuals. Regulators must abandon the old "wait and see" regulatory approach, where a problem has to grow to be national in scope, and perhaps be in the public eye, before it is addressed. Financial regulators must have independence from the entities they oversee and an express charge to regulate for the prevention of harm both to individuals and to the financial system

2. Financial system regulators should give the same priority to consumer protection as to safety and soundness. The mortgage crisis and its aftermath dramatically illustrate that the consumer protection and safety and soundness are inextricably linked Regulators must increase the priority placed on consumer protection.

West Coast Office
1535 Mission Street • San Francisco, CA 94104
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3. Practices and features that make financial products sold to individuals too complex to understand must be stopped. The report speaks in several places about the need for financial literacy or improved disclosure. However, financial products which are too complex for the intended consumer carry special risks that no amount of additional disclosure or information will fix. In subprime mortgages, for example, many homeowners were induced to refinance an existing loan for one that would offer a reduced payment for just the first two years. Others were assured that they could refinance later, yet the loan documents contained an expensive prepayment penalty. Many of the tens of thousands of individuals who filed comments in the Federal Reserve Board's Regulation AA docket on unfair or deceptive credit card practices reported that they learned about harmful card issuer practices apparently permitted by the cardholder agreement only when the practice was first invoked against them. Regulatory reform will be incomplete unless regulators identify and stop practices that make credit and deposit products difficult for individuals to understand and evaluate.

4. Federal and state regulatory diversity is essential to robust oversight. We agree with report that it is important to eliminate the bottlenecks that can be caused by the coordination process between multiple federal regulators. However, no single federal agency leader can foresee all of the consequences of new practices and products. For this reason, Consumers Union supports both an independent federal consumer protection agency for financial services products (with concurrent jurisdiction with existing banking agencies), and the power of states to develop and enforce consumer protections. The swift and troubling developments in the financial meltdown show that we cannot rely on a single federal agency leader to anticipate all of the risks in new practices and products, nor to have the inclination or the resources to pursue all of the areas where law enforcement is needed.

5. Accountability must be built into the financial system. During the build-up to the crisis, loan originators and securitization packagers got fees even if loans couldn't later be repaid. Regulatory restructuring should include changing the incentives in the private market by requiring that everyone who gets a fee in connection with a credit product also keeps some of the risk of future nonpayment and the risk of problems with the loan. In addition, everyone who offers financial products to consumers should be subject to suitability requirements and fiduciary duties.

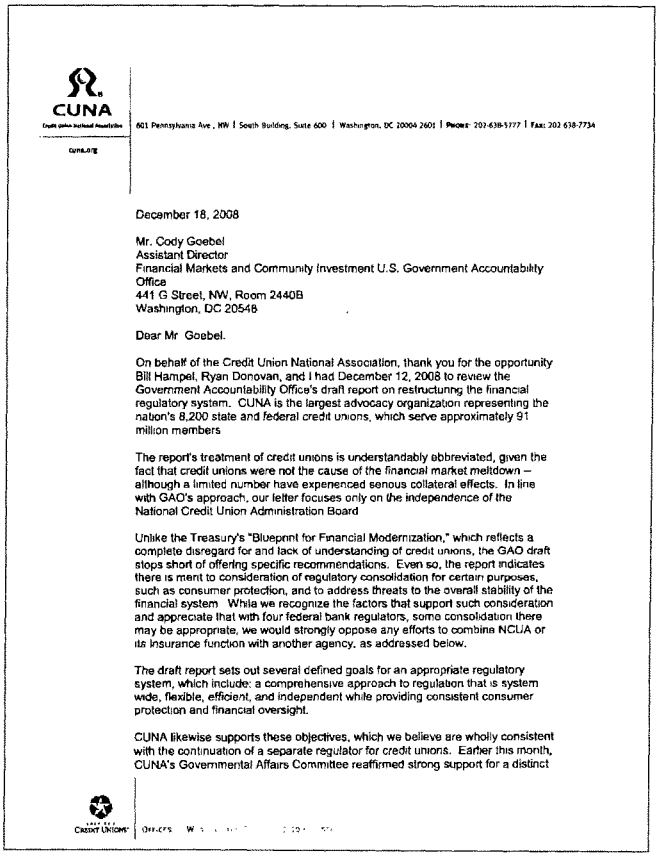
We appreciate the work of the GAO in this important issue area. Creating a strong, trusted regulatory structure for financial products and the financial markets is essential to rebuilding the public confidence in the U.S. financial markets.

Very truly yours,

Gail Hillebrand
Financial Services Campaign Manager
Consumers Union of U.S., Inc.

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Appendix VII: Comments from the Credit Union National Association



CUNA

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | Phone: 202-638-5777 | Fax: 202 638-7734

December 18, 2008

Mr. Cody Goebel
Assistant Director
Financial Markets and Community Investment U.S. Government Accountability Office
441 G Street, NW, Room 2440B
Washington, DC 20548

Dear Mr Goebel.

On behalf of the Credit Union National Association, thank you for the opportunity Bill Hampel, Ryan Donovan, and I had December 12, 2008 to review the Government Accountability Office's draft report on restructuring the financial regulatory system. CUNA is the largest advocacy organization representing the nation's 8,200 state and federal credit unions, which serve approximately 91 million members

The report's treatment of credit unions is understandably abbreviated, given the fact that credit unions were not the cause of the financial market meltdown – although a limited number have experienced serious collateral effects. In line with GAO's approach, our letter focuses only on the independence of the National Credit Union Administration Board

Unlike the Treasury's "Blueprint for Financial Modernization," which reflects a complete disregard for and lack of understanding of credit unions, the GAO draft stops short of offering specific recommendations. Even so, the report indicates there is merit to consideration of regulatory consolidation for certain purposes, such as consumer protection, and to address threats to the overall stability of the financial system While we recognize the factors that support such consideration and appreciate that with four federal bank regulators, some consolidation there may be appropriate, we would strongly oppose any efforts to combine NCUA or its insurance function with another agency, as addressed below.

The draft report sets out several defined goals for an appropriate regulatory system, which include: a comprehensive approach to regulation that is system wide, flexible, efficient, and independent while providing consistent consumer protection and financial oversight.

CUNA likewise supports these objectives, which we believe are wholly consistent with the continuation of a separate regulator for credit unions. Earlier this month, CUNA's Governmental Affairs Committee reaffirmed strong support for a distinct

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federal regulator as long as it provides rigorous, effective supervision that enhances their financial strength and is well-tailored to the level of risk credit unions demonstrate. At the same time, credit unions need and deserve a regulator that will facilitate, not stymie, their capabilities to provide innovative yet safe services to their consumer-members at favorable rates. While urging NCUA's independence, credit unions also appreciate the need for the agencies to address certain issues collectively, and to that end CUNA has recommended NCUA be included in the Presidential Working Group, which is currently comprised of the banking regulators but not NCUA.

Another goal the GAO draft includes is to minimize taxpayers' exposure in the event problems arise. To that end, the credit union regulatory structure combines the enforcement of demanding safety and soundness standards under NCUA's prompt corrective action provisions with an approach that seeks to contain credit union problems within the system. Virtually all of the funds to operate NCUA and the NCUSIF are provided by the credit union system, without reliance on taxpayer dollars, and since its inception in 1978, the NCUSIF has achieved a commendable record in managing problem cases and avoiding taxpayer losses. Another example of credit unions' self-sustaining efforts is their advocacy for the use of NCUSIF funds to purchase troubled assets from the limited number of natural person credit unions that might need such assistance first, before seeking back-up assistance from the Treasury's Troubled Asset Relief Program.

For many credit unions, maintaining a separate regulator is critical to their preservation as institutions with fundamentally different motivations than other financial intermediaries have. Credit unions are operated by volunteer boards who do not receive economic inducements to serve but rather serve to meet the financial needs of their member-owners. Banks are motivated by the need to reward their stockholders first, and then their customers. Because of these core differences, only a separate, effective regulator will provide the singular focus necessary to further credit unions' distinctiveness, thereby ensuring consumers will continue to have choices in the financial marketplace.

Again, thank you for the opportunity to provide these comments following the review of your draft. Please do not hesitate to contact any one of us if you have questions about credit unions or this letter. All the best for happy holidays.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
CUNA Deputy General Counsel and
Senior Vice President

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Appendix VIII: Comments from the Federal Deposit Insurance Corporation

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

December 10, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The FDIC appreciates the opportunity to provide comments on the GAO's report titled Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. We understand that this report is self-initiated, and is intended to provide a set of principles by which policymakers can evaluate various proposals to restructure the U.S. financial regulatory system. We commend the GAO for undertaking this important project.

As an overarching premise, the report states that the U.S. financial regulatory structure is in need of modernization. The FDIC agrees that effective reform of the U.S. financial regulatory system would help avoid a recurrence of the economic and financial problems we are now experiencing.

As we consider recent experience, two issues related to U.S. financial regulatory performance stand out to us as being of particular concern. First, our regulatory structure collectively did not address a systematic breakdown in lending standards in wide segments of the U.S. mortgage market. An important lesson that should be incorporated in any regulatory reform proposal is that irresponsible or abusive lending practices are consistent neither with safe-and-sound banking nor with sustainable economic growth.

Second, the regulatory structure collectively permitted excessive leverage in the non-bank financial system. Facing no explicit leverage constraints, and lulled by quantitative models and agency ratings into believing risks were minimal, a variety of large investment banks, financial guarantee insurers and hedge funds operated with a degree of leverage that significantly diminished their ability to withstand financial stress. An important lesson from recent years is that unconstrained leverage places not only individual firms at risk, but greatly increases the severity of financial market downturns and imposes significant costs on taxpayers.

These two issues were not addressed as effectively as they should have been, in part because of regulatory gaps, and in part because of regulatory choices about how to exercise existing authority. Thus, while the role of regulatory structure is an important part of improving regulatory performance, statutory mandates for the regulators are of equal importance. Existing prompt corrective action law is a good example of a successful mandate. Any regulatory reform proposal should include consideration of appropriate mandates in the area of consumer protection. For example, some lending practices can be so egregious as to warrant their outright

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prohibition, as opposed to placing sole reliance on promoting financial literacy or improving disclosures. Regulatory reform proposals should also consider statutory mandates for leverage constraints for non-bank financial firms, and well-defined mechanisms to protect taxpayers from the cost of financial bailouts.

We believe the experience of recent years strongly supports the importance of an independent FDIC with the resources and authority to safeguard the government's financial stake in federal deposit insurance and promote public confidence in the banking system. The FDIC's independent perspective has been evidenced in recent years by its actions addressing both individual troubled financial institutions and systemic risk, strengthening our deposit insurance system, ensuring capital safeguards in the implementation of Basel II's advanced approaches, and promoting confidence in the banking system by promoting financial literacy, educating consumers about deposit insurance and taking actions to protect consumers.

Thank you once again for the opportunity to comment on this report. As always, we have appreciated the professionalism with which the GAO's review team conducted this assignment.

Sincerely,

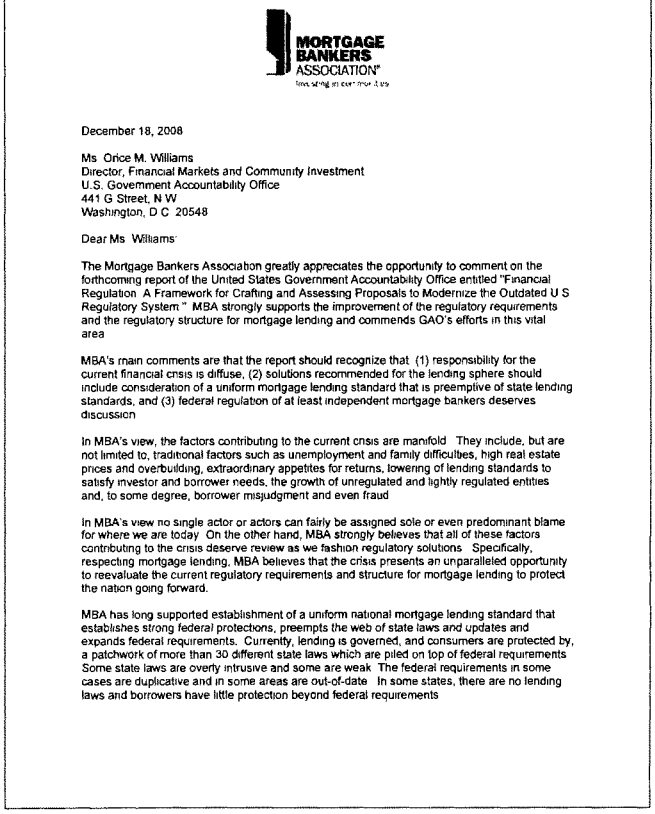
Sandra L. Thompson
Director

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Appendix IX: Comments from the Mortgage Bankers Association



MORTGAGE BANKERS ASSOCIATION

December 18, 2008

Ms Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N W
Washington, D C 20548

Dear Ms Williams:

The Mortgage Bankers Association greatly appreciates the opportunity to comment on the forthcoming report of the United States Government Accountability Office entitled "Financial Regulation A Framework for Crafting and Assessing Proposals to Modernize the Outdated U S Regulatory System " MBA strongly supports the improvement of the regulatory requirements and the regulatory structure for mortgage lending and commends GAO's efforts in this vital area

MBA's main comments are that the report should recognize that (1) responsibility for the current financial crisis is diffuse, (2) solutions recommended for the lending sphere should include consideration of a uniform mortgage lending standard that is preemptive of state lending standards, and (3) federal regulation of at least independent mortgage bankers deserves discussion

In MBA's view, the factors contributing to the current crisis are manifold They include, but are not limited to, traditional factors such as unemployment and family difficulties, high real estate prices and overbuilding, extraordinary appetites for returns, lowering of lending standards to satisfy investor and borrower needs, the growth of unregulated and lightly regulated entities and, to some degree, borrower misjudgment and even fraud

In MBA's view no single actor or actors can fairly be assigned sole or even predominant blame for where we are today On the other hand, MBA strongly believes that all of these factors contributing to the crisis deserve review as we fashion regulatory solutions Specifically, respecting mortgage lending, MBA believes that the crisis presents an unparalleled opportunity to reevaluate the current regulatory requirements and structure for mortgage lending to protect the nation going forward.

MBA has long supported establishment of a uniform national mortgage lending standard that establishes strong federal protections, preempts the web of state laws and updates and expands federal requirements. Currently, lending is governed, and consumers are protected by, a patchwork of more than 30 different state laws which are piled on top of federal requirements Some state laws are overly intrusive and some are weak The federal requirements in some cases are duplicative and in some areas are out-of-date In some states, there are no lending laws and borrowers have little protection beyond federal requirements

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MBA believes legislators should look at the most effective state and federal approaches and work with stakeholders to fashion a new uniform standard which is appropriately up-to-date, robust, applies to every lender, and protects every borrower It should be enacted by the Congress and preempt state laws A uniform standard would help restore investor confidence and be the most effective and least costly means of protecting consumers against lending abuses nationwide Having one standard would avoid undue compliance costs, facilitate competition and ultimately decrease consumer costs.

MBA recognizes that one of the key objections to a preemptive national standard is that it would not be flexible and adaptable and preclude state responses to future abuse MBA believes this problem is surmountable and could be resolved by injecting dynamism into the law One approach would be to supplement the law as needed going forward with new prohibitions and requirements formulated by federal and state officials in consultation

Currently, some mortgage lenders are regulated as federal depository institutions, some as state depositories and some as state-regulated non-depositories. MBA believes that along with establishment of a uniform standard, a new federal regulator for independent mortgage bankers and mortgage brokers should be considered and MBA is interested in exploring that possibility

A new regulator should have sufficient authorities to assure prudent operations to address financing needs of consumers If such an approach is adopted, states also could maintain a partnership with the federal regulator in examination, enforcement and licensing MBA believes the combined efforts of state and federal officials in regulatory reviews and enforcement under a uniform standard would greatly increase regulatory effectiveness and focus.

Notably, any new regulatory scheme should address the differing regulatory concerns presented by mortgage bankers and by mortgage brokers, considering their differing functions and the differing policy concerns which the respective industries present MBA has written extensively on this subject and commends to GAO's attention the attached report entitled *Mortgage Bankers and Mortgage Brokers Distinct Businesses Warranting Distinct Regulation* (2008).

Again, MBA strongly believes today's financial difficulties present an unparalleled opportunity to establish better regulation in the years to come Today's financial crisis reminds us daily that financial markets are national and international in scope As the crisis worsened, the world looked to national and international governments for solutions MBA believes it would be unwise not to use this moment to establish a national standard and cease dispersing regulatory responsibility, to help prevent crises ahead

Thank you again for the opportunity to comment

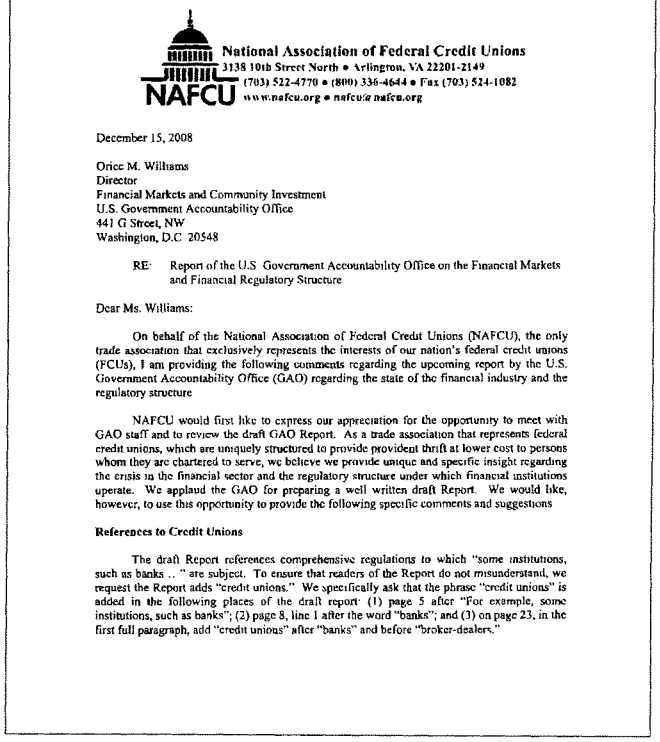
Sincerely,

John A. Courson

John A Courson
Chief Operating Officer
Mortgage Bankers Association

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Appendix X: Comments from the National Association of Federal Credit Unions



National Association of Federal Credit Unions
3138 10th Street North • Arlington, VA 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax (703) 524-1082
www.nafcu.org • nafcu@nafcu.org

December 15, 2008

Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, D.C 20548

RE: Report of the U.S Government Accountability Office on the Financial Markets and Financial Regulatory Structure

Dear Ms. Williams:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions (FCUs), I am providing the following comments regarding the upcoming report by the U.S. Government Accountability Office (GAO) regarding the state of the financial industry and the regulatory structure

NAFCU would first like to express our appreciation for the opportunity to meet with GAO staff and to review the draft GAO Report. As a trade association that represents federal credit unions, which are uniquely structured to provide provident thrift at lower cost to persons whom they are chartered to serve, we believe we provide unique and specific insight regarding the crisis in the financial sector and the regulatory structure under which financial institutions operate. We applaud the GAO for preparing a well written draft Report. We would like, however, to use this opportunity to provide the following specific comments and suggestions

References to Credit Unions

The draft Report references comprehensive regulations to which "some institutions, such as banks .. " are subject. To ensure that readers of the Report do not misunderstand, we request the Report adds "credit unions." We specifically ask that the phrase "credit unions" is added in the following places of the draft report: (1) page 5 after "For example, some institutions, such as banks"; (2) page 8, line 1 after the word "banks"; and (3) on page 23, in the first full paragraph, add "credit unions" after "banks" and before "broker-dealers."

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Also, we ask that the phrase "non-credit union" is added after "non-bank" on page 17, Figure 2. Similarly, "non-credit unions" should follow "non-banks" on page 23 in the subheading that presently reads "Activities of NonBank Mortgage Lenders Played A Significant Role." As you are aware, the non-banks referenced in the figure are also non-credit unions. As such, we believe the figure would be clearer if it more clearly explains that the non-banks are also not credit unions

Framework for Regulatory Restructuring

A key aspect of the draft report is the provision of nine elements as a framework to restructure the financial regulatory system. While we believe the framework contains sound ideas, we strongly recommend that you fully incorporate the need to ensure that smaller institutions, particularly credit unions, are not inadvertently overlooked in any restructuring that Congress may institute.

We are particularly concerned about Element Two and Element Eight. Element Two recommends a single "market stability regulator." Element Eight recommends consistent financial oversight. As we have previously expressed to GAO staff, we believe an independent regulator should continue to oversee and examine federal credit unions. The distinctive characteristics of federal credit unions, including their cooperative structure and mission to provide provident service at lower cost to those they are chartered to serve, necessitates that they are regulated by an independent entity. Accordingly, we request that these two elements are revised to reflect the need of an independent regulator for federal credit unions.

NAFCU appreciates this opportunity to share its comments on this interim rule. Should you have any questions or require additional information please call me at (703) 522-4770 or (800) 336-4644 ext. 268.

Sincerely,

Tessema Tefferi
Associate Director of Regulatory Affairs

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Appendix XI: Comments from the Center for Responsible Lending, the National Consumer Law Center, and the U.S. PIRG

December 16, 2008

VIA EMAIL AND U S MAIL

Ms Orice M Williams (williamso@gao gov)
Director, Financial Markets and Community Investment
U S Government Accountability Office
441 G Street, N W
Washington, D C 20548

with copies via email to
Mr Cody Goebel, Assistant Director (goebelc@gao gov)
Mr Randall Fasnacht (fasnachtr@gao gov)

Re Comments on Draft Report, GAO-09-216

Dear Ms Williams

We appreciate the opportunity to review the draft report at your offices on December 4, and to offer comments These are offered jointly by CRL, the National Consumer Law Center and USPIRG

The report is a thoughtful and thorough review of the structural issues regarding regulatory reform We especially appreciate that your report notes the problem of charter competition and the distorting impact of the funding structure for the banking regulators

We would like to preface our comments by stating the obvious – that this review does not occur in a vacuum, but rather in the context of a major crisis which exposed fundamental weaknesses on many fronts. The structural problems in the federal regulator system are but one Some of these comments derive not from the specific content of the report, but the messages conveyed by some of the references to other aspects of the crisis, such as the nature of the market and consumer behavior Another especially important comment derives as much from what is left unsaid Perhaps it seems as though it should go without saying, but given much of the debate that this crisis has engendered, we fear that without at least an acknowledgement of what is not addressed by your report, necessary reminders of other integral parts of regulatory reform may be lost

While the structure of regulation can create its own problems, such as the potential for charter competition and regulatory capture that you note, regulators also need tools (in the form of laws to enforce, or directives to promulgate rules in furtherance of such laws), adequate resources and, above all, the will to regulate No amount of structural reform will succeed if regulators have no charge to fulfill in their job, nor the will to do so We have had three decades of a deregulatory agenda, and without a change in that overarching view, structural changes will be insufficient We recognize that the prevailing philosophy of regulation was not the focus of this report However, we believe that any discussion of regulatory structural reform must be accompanied by an explicit caveat that it addresses only one aspect of the overall regulatory issues that contributed to

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this crisis, and that changing the structure, alone, will be insufficient if these other necessary conditions for effective oversight are not reformed, as well

Beyond that overarching context for regulatory reform, we offer the following comments

1. The best way to avoid systemic risk is to address problems that exist at the level of individual consumer transactions, before they pose a threat to the system as a whole.

The report appropriately addresses the need to effectively monitor and regulate problems that threaten the financial system as a whole However, the most effective way to address systemic risk is to identify market failures that threaten abuse of individual consumers, and to address these failures before they threaten the system as a whole The crisis today would not have reached its current state had problems been addressed and prevented before they evolved into the foreclosure epidemic now underway

The report correctly notes that most *subprime* lending was done by nonbank lenders who were not subject to oversight by the federal banking agencies [1] However, the market failures that contributed to the current crisis are not limited to the subprime market The failure of the Alt-A market, including poorly underwritten non-traditional loans, are also significant contributors, as is becoming increasingly apparent The failures of IndyMac and Washington Mutual, among others, are largely the function of overly aggressive lending of risky products that were unsuitable for far too many borrowers, and these did occur under the watch of the federal banking agencies Though the federal banking agencies issued some guidelines for nontraditional lending, it was too little and too late Further, to judge from the performance of the late vintages of these loans, even then, they were insufficiently enforced

But in any case, neither bank nor nonbank lenders were subject to adequate consumer protection laws Both banks and non-bank lenders pressed legislators and regulators not to enact such protections Furthermore, banks subject to federal regulation also contributed to the problem by being part of the secondary market's demand for the risky products that permeated the subprime and Alt-A markets [2] The report should make clear that to adequately protect consumers, and avoid systemic risk in the future, whatever regulatory structure emerges will need to be more robust and effective in protecting consumers than the current system has been to date

[1] Further, the threat of federal preemption and its absence of suitable consumer protection gave the nonbank lenders the argument that they just wanted a "level playing field," –on a field largely without rules To that extent, the regulatory structure played into the separate thread of whether there were adequate tools for regulators The preemption agenda was part of the momentum to the lowest common denominator for the substance of regulation

[2] Recent studies have found that the securitization process in fact contributed to the aggressive lending and poor underwriting *See, e g* Benjamin J Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, *Securitization and Screening Evidence From Subprime Mortgage Backed Securities*, pp 26-27 (January 2008), available at http://www2 law columbia edu/contracteconomics/conferences/lawseconomics S08/Vig%20paper pdf

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2. To effectively protect consumers the regulatory system must prohibit unsustainable lending; disclosures and "financial literacy" are not enough.

The fundamental problem at the heart of today's crisis is that loan originators pushed borrowers into loan products that were inherently risky and unsustainable by design, and they did so notwithstanding the availability of the more suitable and affordable loans for which they qualified [3] The most common product in the subprime market in recent years was not merely an adjustable rate mortgage, but rather an adjustable rate mortgage with built-in payment shock that lenders anticipated most borrowers could not afford, but that they could avoid only by refinancing before the payment shock took effect, typically paying typically 3% to 4% of the loan balance as a "prepayment penalty" in order to refinance

According to a Wall Street Journal study, 55% of the borrowers who received such loans in 2005, and 60% of those who received them in 2006, had credit scores high enough to have qualified for lower cost prime loans [4] And even those borrowers who did not qualify for prime could have had 30-year fixed rate loans for approximately 65 basis points above the introductory rate on the loans they received [5] The report suggests incorrectly (pp 43-44) that subprime loans "help[] borrowers afford houses" they could not otherwise afford, when in fact, most subprime loans refinanced existing loans, rather than purchased new homes [6] But in either case, had borrowers been offered the more suitable loans for which many qualified, many more borrowers could have sustained homeownership [7]

The experience with the recent vintages of Alt-A loans are similarly instructive Chris Ferrell, an economics editor with the NPR program Marketplace referred to the Payment Option ARM product (many of which are Alt-A) as "the most complicated mortgage product ever marketed to consumers" The greater the complexity, the less suitable that disclosure is as a "market perfecting" tool Further, the huge jump in payment option ARMS, (from $145 billion to $255 billion from 2004-2007), was primarily possible only by the increasingly poor underwriting Countrywide, one of the major issuers of these

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[3] For more detail on causes of the crisis, *see* Testimony of Eric Stein, Center for Responsible Lending, Before the U S Senate Committee on Banking, Housing and Urban Affairs (October 16, 2008), http://banking.senate.gov/public/_files/RevisedSenateTestimony101608HearingSteinFinalFinal.pdf

[4] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec 3, 2007)

[5] Letter from Coalition for Fair & Affordable Lending to Ben S Bernanke, Sheila C Bair, John C Dugan, John M Reich, JoAnn Johnson, and Neil Milner (Jan 25, 2007) at 3

[6] *See, e g* Subprime Lending *A Net Drain on Homeownership*, CRL Issue Paper, No 14 (March 27, 2007)

[7] *See, e g* Lei Ding, Roberto G Quercia, Wei Li, and Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages Disaggregating Effects Using Propensity Score Models*, Center for Community Capital, Univ of North Carolina & Center for Responsible Lending (Working Paper, Sept 13, 2008)

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loans (that issued them under both its national bank and federal thrift charters, as well as some of its non-depository entities) admitted that an estimated 80% of its recent POARMs would not meet the late 2006 federal guidelines [8]

The Federal Reserve has noted that, given the misaligned incentives of originators and the complexity of products and loan features, even with increased information or knowledge, borrowers could not have defended against poorly underwritten, risky products and deceptive practices. The main problem with these loans was not the inadequacy of the disclosures or the financial literacy of the borrowers. Rather, the fundamental problem was that -- as the federal banking regulators belatedly recognized with respect to non-traditional loans in late 2006 and subprime lending in 2007 -- lenders should not have made loans that they knew borrowers would be unable to sustain without refinancing.

3. To effectively protect consumers, the regulatory system must monitor and address market incentives that encourage loan originators to push risky or unsuitable loan products.

The report correctly notes that market incentives encouraged loan originators to extend excessive credit (p. 22). It should also note that these same incentives encouraged them to push riskier productions and features than the borrowers qualified for [9]. The report should note the need for regulatory oversight of market failures that reward market participants for irresponsible behavior.

We understand that philosophies of consumer protection and the adequacy of consumer protection laws is not your intended focus. However, there were occasional statements in the report which, intended or not, seemed to convey a message that improved disclosure or literacy would be adequate. Yet more people -- including some of the regulators themselves -- are recognizing that in an era of highly complex products and unseen perverse incentives, disclosure is an insufficient tool, and literacy is an elusive goal.

We would be happy to provide further information.

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[8] Countrywide, *3Q 07 Earnings Supplemental Presentation* (October 26, 2007). To again emphasize that the federal banking regulators contributed to the problem, some $161 billion of those payment option ARMs were issued when Countrywide was under the OCC's watch.

[9] After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?" Vikas Bajaj and Christine Haughney, *Tremors at the Door. More People with Weak Credit Are Defaulting on Mortgages*, New York Times (January 26, 2007).

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Sincerely,

Center for Responsible Lending

National Consumer Law Center

US PIRG

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Appendix XII: GAO Contacts and Staff Acknowledgments

GAO Contacts	Orice M. Williams, (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman, (202) 512-8678 or hillmanr@gao.gov.
Staff Acknowledgments	In addition to the contacts named above, Cody Goebel (Assistant Director), Kevin Averyt, Nancy Barry, Rudy Chatlos, Randy Fasnacht, Jeanette Franzel, Thomas McCool, Jim McDermott, Kim McGatlin, Thomas Melito, Marc Molino, Susan Offutt, Scott Purdy, John Reilly, Barbara Roesmann, Paul Thompson, Winnie Tsen, Jim Vitarello, and Steve Westley made key contributions to this report.

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Related GAO Products

Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency. GAO-09-161. Washington, D.C.: December 2, 2008.

Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed. GAO-08-200. Washington, D.C.: January 24, 2008.

Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments. GAO-08-78R. Washington, D.C.: October 16, 2007.

Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure. GAO-08-32. Washington, D.C.: October 12, 2007.

Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration. GAO-07-154. Washington, D.C.: March 15, 2007.

Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved. GAO-06-1021. Washington, D.C.: September 19, 2006.

Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers. GAO-06-929. Washington, D.C.: September 12, 2006.

Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure. GAO-05-61. Washington, D.C.: October 6, 2004.

Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending. GAO-04-280. Washington, D.C.: January 30, 2004.

Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk. GAO/GGD-00-3. Washington, D.C.: October 29, 1999.

Financial Derivatives: Actions Needed to Protect the Financial System. GAO/GGD-94-133. Washington, D.C.: May 18, 1994.

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